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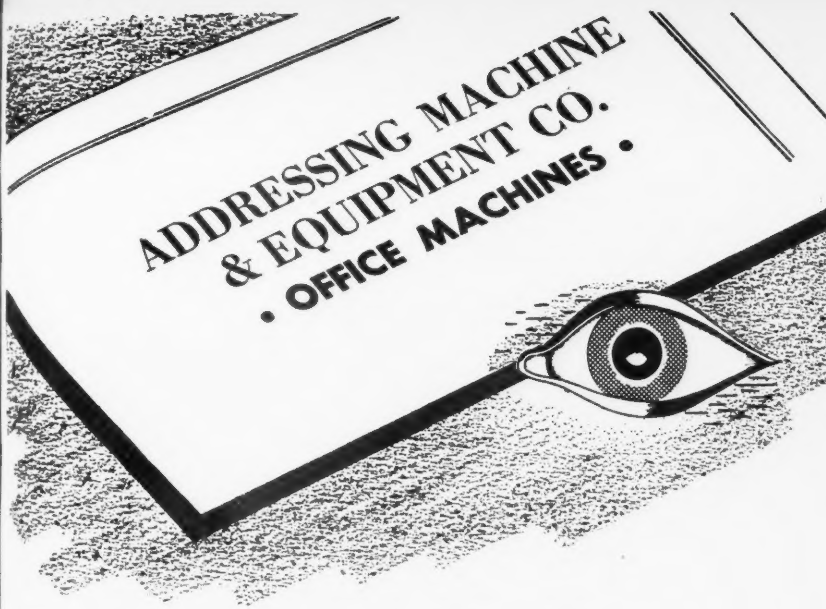

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THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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Developments in Auditing Procedures Since the Extension of Such Procedures in 1939

By NORMAN J. LENHART, C.P.A.

THE subject matter of this paper might indicate that in 1939 there was a sudden addition to usual auditing procedures, but I do not believe that actually such was the case. Many independent public accountants for some years prior to 1939 had been generally following the so-called extended procedures relating to inventories and receivables as outlined in the 1939 report entitled *"Extensions of Auditing Procedure."* I believe that report did force general acceptance of the recommended auditing procedures regarding inventories and receivables.

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> This paper was presented by him on May 12, 1947, at the Annual Meeting of the Society.

Since 1939 the American Institute committee on auditing procedure has issued 22 bulletins. Several of those bulletins amplified or explained portions of the previously referred to report entitled *"Extensions of Auditing Procedure."*

Two bulletins were regarding accountants' certificates. The form of certificate set forth in Statements on Auditing Procedure Nos. 5 and 6 has been followed rather generally by independent public accountants. However, you will see variations from the recommended form, some because of the particular circumstances of an engagement and some because of the feeling on the part of certain independent public accountants that the so-called standard form is not wholly satisfactory.

There has been criticism of the standard form of certificate in that some persons believe the reference to review of the system of internal control may imply, unless something is said to the contrary, that the auditor approves the system reviewed. Some firms have taken this possibility so seriously that they have eliminated reference to the system of internal control in the certificates they customarily sign.

There has not been published any generally accepted or authoritative statement defining "generally accepted auditing standards applicable in the circumstances." It is hoped that the committee on auditing procedure will issue a statement clarifying this matter and perhaps taking the position that the words "applicable in the circumstances" should relate to procedures rather than standards.

I suppose members of this Society assume that every independent public accountant has read *Extensions of Auditing Procedure* and reads not only all *Statements of Auditing Procedure* but also other published material relating to auditing procedures. However, it does not seem that such is the case. Some of you may not have seen the letter, dated December 20, 1946, signed by Mr. Wilcox, President of American Institute of Accountants, to the members of the Institute on the subject of auditing standards and procedures. The letter is short and I would like to read it to you.

"From time to time the American Institute of Accountants receives from various sources criticisms of audit work by certified public accountants in specific cases. A collection of such criticisms has been made by the Institute's research department, from which a summary of typical "horrible examples" has been made and is attached hereto.

"Every one of the cases cited shows ignorance or disregard of fundamental auditing standards or procedures amply described in the professional literature, and long since recognized by the profession itself as essential.

"These cases may be rare exceptions of inferior work but they are disquieting because we have no way of knowing how exceptional they are.

"During the war years the accounting profession has been preoccupied with problems other than auditing procedure. Since 1939 several thousand new certified public accountants have been created in the United States. Many new members have been admitted to the Institute and to the state societies. Some of these new arrivals may not be fully conscious of the existence of such documents as "Examination of Financial Statements by Independent Public Accountants," "Extensions of Auditing Procedure," and the other 21 statements on auditing procedure issued by the committee on auditing procedure of the American Institute of Accountants, as well as other authoritative literature in this field. They may be unaware of the fact that the rules of professional conduct of the Institute, and of most of the state societies, subject members to reprimand, suspension, or expulsion for failure to observe generally accepted auditing standards: and that ignorance of such standards might result in loss of their CPA certificates and disbarment from practice before certain government regulatory agencies, and possibly in heavy civil liabilities.

"It is suggested, therefore, that members of the Institute engaged in public accounting practice review their own auditing procedures, in order to make certain that they are in conformity with the standards which the profession has accepted as a measure of its responsibility. Every independent auditor should be thoroughly familiar with the indispensable steps which must be taken if he is to give an unqualified opinion.

"Future opportunities of the accounting profession are contingent largely on continued public confidence in the ability and independence of the certified public accountant. Cases such as those described in the enclosed memorandum reflect discredit on the profession as a whole, and thus indirectly impair the opportunities of every practitioner."

Even though no member of this Society would be guilty of some of the practices or lack of practices cited in the memorandum attached to Mr. Wilcox's letter any such condition is certainly of concern to all of us. Also, published material relating to proceedings against independent public accountants by the Securities and Exchange Commission are of interest. It is distasteful to read the statements made in SEC Accounting Series Release No. 48 regarding a former member of the American Institute of Accountants who stated that he was unfamiliar with the standards of professional conduct promulgated by the State Board of Accountancy of his State and was unfamiliar with the standards of professional conduct adopted by the American Institute of Accountants. There is a slight element of humor in SEC Accounting Series Release No. 51 in which the defense made by a certified public accountant for failure to make anything

approaching a reasonable examination was that he was in a hurry to get away on vacation.

One of the most important parts of an audit is the forming of an opinion as to whether or not the financial statements are in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Since 1939 the American Institute committee on accounting procedure has issued 27 accounting research bulletins of which several related to special war problems. I hope every member of the Society is familiar with the accounting research bulletins and, therefore, I will not make special comment with regard to any of them.

It may be noted that some few of the accounting research bulletins have become obsolete and also that some reflect rather strong dissent on the part of certain members of the committee.

I understand each member of the Society receives a copy of each of the American Institute Statements on Auditing Procedure and Accounting Research Bulletins.

I believe one of the most important developments relating to auditing procedure is the receipt, by the American Institute of Accountants, of letters from 34 companies issuing fidelity bonds in which such companies have generally agreed that they will not assert claims against accountants in any cases not involving affirmative dishonest or criminal acts or gross negligence on the part of accountants, and that claims in any case shall not be asserted except after an impartial hearing in the matter by a committee of three persons. An article appeared in the "*Controller*" for March, 1947, written by John L. Carey, Secretary of the American Institute of Accountants, entitled "Defalcation in Relation to Audit, Internal Control and Fidelity Bonds." This article was reprinted on page 353 of the April, 1947, *Journal of Accountancy* and should be read not only by every independent public accountant but also by his clients. Auditing procedures have been influenced by the possibility of suit against the independent public accountant for failure to discover defalcations which generally accepted auditing procedures should not be expected to disclose. As Mr. Carey points out, the best defense against defalcations requires an integration of internal control, audits and fidelity bonds.

There is not yet general recognition of the fact that few of the items in a financial statement can be determined with exactness and that generally accepted auditing procedures may fail to detect immaterial errors or misstatements, even in such an item as cash.

It has been rather generally accepted that if an auditor reviews a client's year-end bank reconciliation, checks the footings and independently confirms the balance in bank, obtains a bank statement and paid checks directly from the bank on, say, the tenth day following the year-end, makes an independent reconciliation of the second balance and checks and foots the recorded deposits and disbursements during the ten day period and follows certain other related procedures the auditor has not only verified the year-end balance but has made proper investigation of unrecorded checks outstanding at the year-end and charge-backs.

However, I recently came across a case in which the foregoing procedure did not and could not detect a defalcation. The cashier involved had not mailed certain recorded checks but managed to have cashed other checks aggregating the same total amount. Certain other auditing procedures happened to disclose what the cashier had done.

It seems to me that year by year there is an increase in the degree of skill and judgment required of the independent public accountant. I am sure future developments in auditing procedure will be accompanied by a continued improvement in the average of the ability of the independent public accountant.

Types of Events Occurring After the Balance Sheet Date Requiring Consideration in the Presentation of Financial Statements

By CAROL F. HALL, C.P.A.

BECAUSE of the diverse factors which enter into the consideration of this subject, it seems to me that the discussion has become rather confused. Some of the factors have always been considered a part of the normal auditing procedures. Others have never been considered and it is necessary to deal separately with these classifications.

In Mr. Blough's article in the *Journal of Accountancy* for March of 1947, he has divided the post-audit events into three categories. These seem to be a reasonably natural division and I think bring out the aforementioned diversity of factors. These three groups are designated by him as:

(a) Adjustment Accounting Group
(b) Future Accounting Group
(c) Non-Accounting Group

The first of these, the Adjustment Accounting Group, contains those items which form a basis for testing the fairness of prior estimates and which would result in adjustments to the statements for a period prior to that in which they occur. Examples of items falling into this class would be the settlement of receivables due from others; retroactive changes in the tax law; returned sales of a subsequent period; and other similar items. Almost all of these represent the culmination of transactions not completed at the close of the fiscal period and it is natural that consideration should be given to such events in the presentation of the financial statements. If, for instance, the audit discloses that a claim has been filed against the corporation and suit brought in connection therewith, the most natural question is, "Has the suit subsequently been tried and settled?" and its outcome in a subsequent period is naturally taken into account in setting up a proper liability. In large part, information with respect to these items has always been brought to light as a result of normal auditing procedures and, except for a timing factor which I will touch on later, there does not seem to be a requirement for changes in procedure.

The second group of items, which Mr. Blough termed The Future Accounting Group, relates to events in a subsequent period which will result in financial adjustments of the company's statements in such subsequent period. Examples of this type are fire losses; sales of significant portions of the productive facilities of the business; expansion of production either through the acquisition of new plants or development of new products; collection of life insurance on the death of an officer;

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This paper was presented by him on May 12, 1947, at the Annual Meeting of the Society.

changes in capital structure; the initiation of sizable damage suit proceedings. In general, these events do not require adjustment of the financial statements, since they do not affect (with the possible exception of the last item) the financial position of the company at the balance sheet date nor the results of its operations for the period then ended. They are, however, important to a prospective investor or creditor in his consideration of the financial statements as indicative of the future operations of the company. This field has not been as clearly covered in the past as the Adjustment Accounting section, but it is the modern trend of thought in accounting that the reader of the statements is entitled to know all items of this character and consequently there has been a growing tendency to insert footnotes in the financial statements calling attention to such items. It is, of course, much more difficult to devise auditing procedures which will uncover all such items, although many will come to the attention of the accountant during the course of his examination.

The third group is designated the Non-Accounting Group and is made up of events which, while they will have some bearing on the future operations and financial position of the company, will not be reflected directly in the accounting records. Examples of this type are: changes in the management; inventions of new products; unionization of plants, etc. While some considerable time is spent by Mr. Blough in discussing these items, it seems to me that they fall generally into the class where if events had occurred during the year under review, no mention would be made of them in the financial statements, although, of course, their effect on the accounting statements would be reflected in greater or less profits. Admittedly they have some significance with relation to a prospective investor or creditor, but in recognizing them even in footnotes it seems to me that the accountant is treading on extremely dangerous ground in that he is seeking to impute either a favorable or an adverse effect on the future financial statements to an event whose effect cannot be clearly demonstrated. It is, of course, evident that the line of demarcation between each of these categories is a hair line and some events may overlap or fall into two of the three classes.

Consideration should also be given to the time in which such events occur. Three periods of time have a bearing on the consideration of the treatments from an accounting point of view of such events. If the events occur during the period from the date of the balance sheet to the completion of the field work on the audit, it is reasonable to expect the accountant to devise some procedures under which material items will be discovered. In fact, this is the only period in which events could be disclosed by audit procedures, unless a requirement is made that at a future date a special examination be made for the purpose of uncovering items of this character.

However, after the completion of the field work, there may be a considerable delay before the report is rendered. This delay may arise from several reasons: the accountant may have to take care of other pressing work, although probably this will not result in any substantial delay if the accountant wishes to do the work again; there may be one or two or three special points which require special consideration between the accountant and the management and before an agreement is reached on these points, considerable time may elapse, probably because of the difficulty in arranging a time for meeting or possibly because of the absence from the company's offices of executives who have to be consulted with regard to these points, who may be away from the office either on business trips or on vacation; an important item in the financial statements may be a foreign account in respect of which the accountant may insist upon receiving a

confirmation. However these occur, this creates a period in which the accountant is not in intimate contact with the client and during such periods, events may occur which would only be disclosed by means of a special examination.

Even after this period, a further period starts from the date of the report to the date on which additonal reports may be required. This is particularly true of the larger companies who are required to file annually, within 120 days of the close of their fiscal year, reports with the Securities and Exchange Commission. Significant events may occur during this period and again the accountant is not in intimate touch with the affairs of the client. While there is no specific indication that even the S.E.C. imposes a responsibility on accountants for such events occurring after the completion of the field work in an audit and possibly even after the date of the report, there is some question as to the attitude that the commission might take should there be an omission to state a material fact because the event occurred in such periods.

The question arises again when a public offering is made of securities which may be within six months from the date of the balance sheet. Here, however, generally the accountant is again in touch with the affairs of the client through his work on the registration statement and he would have a little greater opportunity to obtain knowledge of material events. A somewhat analogous situation may occur in smaller engagements where a report is requested by the client for submission to a credit grantor or even a prospective investor.

It has been suggested a number of times that the responsibility of the accountants might be limited by his dating his report as of the close of the field work or at least dating of subsequent reports as of the date of his first report on the client's affairs for the period involved. If this procedure has any effect, it is, of course, purely legal in character in limiting the responsibility of the accountant. It would seem, however, that the accountant could not lose by such a policy and that he might be able to sustain a position which would result in a proper limitation of his responsibility.

While I may be getting a trifle afield of the subject, it is interesting to note that there have been many instances of special examinations which parallel the disclosure of events subsequent to the audit date. In almost all security offerings, it has been the practice for many years for the underwriters to request a letter from the accountants as of the date of the offering of securities in which the accountant states that there has been no material adverse change in the financial position of the company since the date of the last audited report. This has entailed a special examination of the records and the making of inquiries from the client's responsible officials in order to put the accountant in a position to write such a letter. In addition, the letter must be carefully worded so as to indicate that the responsibility taken by the accountant is considerably less than that taken as result of an audit. It is, of course, impossible for the accountant to make a complete audit in the time allotted, as this letter must cover the situation at a particular date and by the very nature of the transacation it must be submitted within a very short period after the date.

A similar situation may well arise on smaller enagements where considerable time has elapsed since the last audit and where a loan is requested from a credit grantor or an investment is being considered by a private investor. In such instances the accountants may be asked to make an examination similar in scope to that requested by the underwriters, in order to give the parties interested some assurance that significant adverse events have not occurred.

While special examinations of this character are of interest in relation to the subject, it should be borne in mind

that these call for special procedures on the part of the accountant and a special form of letter report. They are, therefore, outside of the ordinary scope of the accountant's examination and a clear line of demarcation should be made in considering the accountant's responsibility for the disclosure of post-audit events.

One further factor might be noted in connection with the events covered. It is usual in the consideration of these items to lay particular stress on those events which result in a disadvantage or loss to the client. Many events, however, have a favorable or profitable effect on the client's financial affairs. It is natural that the accountant should not show the same interest in such favorable events as in the unfavorable ones in view of the well established policy of anticipating losses but not anticipating profits. Accordingly, if the post-audit events which come to light as the result of the accountants' examination are all favorable, it would not seem necessary to disclose them. On the other hand, if all the events are unfavorable, disclosures might well be required. In many instances, however, there will be both favorable and unfavorable events disclosed by the examination and in such cases it would not be inappropriate to include the favorable events in the disclosure as well as those which have an adverse effect.

This subject has been a matter on which considerable thought has been given for the past few years. It would seem, therefore, desirable that the accountant's responsibility for the post-audit events be clarified and I feel that it should cover, as a minimum, all items falling into the Adjustment Accounting class which occur prior to the completion of the field work of the audit. Consideration should also be given to the extension of the normal auditing procedures to cover items of the Future Accounting class so that a reasonable responsibility could be borne by the accountant for their disclosure if they occur during that same time, though this responsibility necessarily would be less than that undertaken by him with regard to the first class of items. In any event, however, there should be a responsibility on the accountant to see that disclosure is made with respect to any material factors of which he has knowledge, no matter how that knowledge is acquired.

Normal Auditing Procedures for the Discovery of Events Occurring Between the Balance Sheet Date and the Time of the Audit

By David S. Siegel, C.P.A.

The ascertainment by the auditor of transactions and information with respect to events which occur between the balance sheet date and the time of an audit is not a new practice. It has been for many years part of what is referred to as standard auditing procedure. Although the auditor is called upon to express his opinion as to the financial status of a business as it existed at the end of some business day, and as to the results of operations during a period commencing on one day and ending on another, he cannot close his eyes to events which occur after that time and which reflect upon the statements or records he is examining.

With respect to balance sheet items, the function of the auditor is to verify the existence and the value of assets and the amounts of liabilities. In order to do so, he is expected to do all within reason to unearth information which has a bearing upon such existence, value and amounts. This includes events and transactions which occur either before or after the statement date and which throw light upon the accuracy of the figures under review. Furthermore, the purpose of the audit is not only to verify the items appearing in the statements and in the books which have been submitted for examination, but also to ascertain whether there are other items which are not reflected in those statements or books but should have been. In short, the auditor should continually be asking himself: "Have I done all that I possibly can do to bring to my attention transactions or events, which have any bearing upon the financial condition of this business as it existed on the balance sheet date or upon the results of operations for the period under review?"

In determining whether an event which occurred after the balance sheet date has a bearing on the financial condition under investigation, we may bear in mind that the value of an item at the balance sheet date should be no better or worse than it subsequently turned out to be. For instance, on the balance sheet date an account receivable may appear to be collectible but subsequent bankruptcy of the customer, who never paid the amount due from him at that time, makes that account truly uncollectible at all times. Similarly, cash in a bank, although subject to no restrictions on the statement date, becomes a questionable asset as the result of the subsequent closing of that bank.

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Let us review some audit steps, which illustrate the well established procedures for ascertaining transactions which occur after the balance sheet date and which are used with the intention of presenting conditions as they actually existed on that date. These illustrations are not intended to be exhaustive. They merely support the fact that looking into the ensuing period is standard auditing procedure. It should be emphasized that the term "between the balance sheet date and the time of the audit" is restricted, of necessity, to that period of time when the auditing processes are conducted in the field. It is possible for the auditor's report to be issued considerably after the field work has been finished, and events such as are described herein may have occurred in the period between the departure from the client's office and the rendering of the audit report. It is not intended to consider the latter events in this discussion.

(a) Cash transactions subsequent to the period under review are examined, or a cash cut-off is made, to determine that reconciling items at the balance sheet date were *bona fide,* and that there then existed no outstanding checks, outstanding deposits and charge backs not accounted for. Petty cash is counted as of the date of the audit but adjusted backward to verify the amount on hand at the balance sheet date.

(b) Notes receivable paid during the interim between the balance sheet date and the audit date may not be available for inspection but they may be verified by reference to the cash receipts and bank deposits in the interim period, or it may be found that the note was not paid on its due date and was actually uncollectible. In carrying out the procedure of verifying the notes by inspection, the auditor may find that some of them are not on hand because they were discounted or pledged as collateral after the balance sheet date. This discovery may have a bearing on the financial condition of the business under review.

(c) Accounts receivable are evaluated by reference to collections after the balance sheet date. Subsequent sales returns are reviewed to see if there are any extraordinary returns and this may indicate that sales during the period under review were fictitious or overstated. Allowances and discounts granted subsequently on balance sheet date accounts are reviewed for the purpose of establishing the adequacy of reserves for such items. Shipments after the close of the period are examined to see that they have not been recorded as sales prior thereto.

(d) In connection with the verification of inventories the subsequent period's purchase and receiving records are examined to verify goods in transit at the statement date. If the auditor was not present at the inventory taking, he may test the accuracy of the quantities at the close of the period by making a count at the time of his audit and reconciling the two counts by addition of sales and deduction of purchases in the interim period. This may be done in conjunction with perpetual inventory records, if the latter are in use.

With respect to inventory price verification, unit selling prices are obtained not only from sales during the period under review but also by reference to sales after the balance sheet date. If the merchandise is sold after the turn of the year for less than its inventory value, this factor is taken into consideration by the auditor in passing upon the proper valuation of the end-of-the-year inventory.

(e) Investments in stocks and bonds which may have been sold or otherwise disposed of during the period between the balance sheet and audit dates, and therefore, cannot be inspected at the time of the audit, are verified by reference to subsequent cash receipts or other records.

(f) The checking of accounts payable and accruals would not be complete without an inspection of the invoices entered in the books in the period

immediately following the balance sheet date. The cash disbursements of the same period are scrutinized for items which should be recorded as of the statement date. Payroll records are examined for the purpose of possible accrual of wages or salaries earned before the balance sheet date but paid thereafter, including such items as "back pay" awards, retroactive wage increases, bonuses to officers and employees, salesmen's commissions, etc.

The auditor should always bear in mind the possibility of additional federal income or other tax assessments made after the balance sheet date but applicable to a period prior thereto. He should inquire about the year last examined by the Treasury Department, and thus he may learn that an additional assessment for some prior year has been made and agreed to subsequent to the statement date.

Some liabilities may have been contingent at the balance sheet date but subsequent events may indicate that they have become definite, such as pending litigation which was ultimately decided against the company, or renegotiation proceedings which ended with a substantial payment to the Government.

(g) With respect to purchase commitments, the contract price is compared not only with the current market price at the date of the balance sheet but also with quoted prices for similar goods after the statement date, and especially the prevailing price at the time of delivery if the latter occurred between the balance sheet date and the date of the audit. This, of course, is done to determine whether a reserve for loss on purchase commitments should appear on the balance sheet. In this connection, firm sales contracts will be taken into consideration and may indicate that no loss will probably occur from the disposal of the merchandise.

The foregoing examples of what has been accepted as standard auditing procedure deal with the books of account and the underlying records pertaining thereto. It is also usual to attempt to obtain relevant data from an examination of the corporate minute book. Pertinent transactions may be revealed by discussions at directors' or stockholders' meetings held after the balance sheet date. Furthermore, inquiries of executives and employees with respect to specific matters are within the scope of an audit. Any incomplete transactions at the balance sheet date should be discussed for the purpose of ascertaining the eventual outcome thereof if that is not reflected by the records already examined.

Most of the items referred to above will result in adjusting entries and will be given effect to in the financial statements. With respect to others, there is not yet general agreement among accountants as to whether they should or should not be incorporated in the statements and even as to whether mention should be made thereof in comments or footnotes.

In the recent discussions of this subject dealing with what the auditor is expected to reveal in his report, a much used example is the one about the fire which destroyed a material portion of the plant after the balance sheet date. In my opinion, the disclosure of this fact is not so important as the performance by the auditor of that part of generally accepted auditing procedure which requires the examination of insurance coverage at the date of the balance sheet, to determine if it is adequate. This includes not only sufficient fire insurance but also such protection as use and occupancy insurance, profits insurance, etc. If the auditor is not satisfied that the company under examination is adequately insured against loss of property, and loss of expected earnings during the period between the time of the fire and the time of resumption of normal operations, it is his duty to make this fact known and that is probably more important in a discussion of audit responsibility than the reporting that a fire occurred.

In this connection, it is timely to

direct your attention to an announcement which recently appeared in the newspapers concerning the Monsanto Chemical Company's loss in the Texas City, Texas, disaster. It was reported that the plant was covered by $14,750,000 insurance, by $7,500,000 use and occupancy insurance to compensate the company for loss of earnings, and by $2,500,000 public liability insurance. An officer of the company emphasized the adequacy of the insurance coverage.

In conclusion, the auditor should not be expected to go beyond reason in ascertaining events and transactions which occurred after the balance sheet date and before the end of the audit. He should not be expected to be a soothsayer or clairvoyant. He should, of course, follow standard auditing procedures, and, having done so, he should be responsible for the ascertainment of no more information than those procedures reveal. Any facts which come to his knowledge as a result of those procedures should be carefully considered by him as to whether they affect the statements on which he is to express his opinion.

Supplementary Auditing Procedures for the Discovery of Events Occurring Between the Balance Sheet Date and the Effective Date of Filing with the Securities and Exchange Commission

By G. CHARLES HURDMAN, C.P.A.

SECTION 11 of the Securities Act of 1933, as amended, imposes civil liabilities upon signers, directors, independent experts and underwriters in case the registration statement on the effective date contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading. Persons other than the issuer shall not be liable, however, provided they can sustain the burden of proof that they have reason to believe, after reasonable investigation, that the statements in the registration were true and that there was no failure to state a material fact or that the statements were not misleading. It is important to note that the date on which the registration statement becomes effective is the significant date as of which the burden of proof rests on all parties to the registration statement.

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This paper was presented by him on May 12, 1947, at the Annual Meeting of the Society.

The Securities Exchange Act of 1934, Section 18(a), provides civil liability for faults or misleading statements in applications, reports or documents filed under the Act. No specific provision is made with respect to omissions. The statements are merely declared actionable if they are misleading. This differs from Section 11 of the 1933 Act under which omission of a material fact required to be stated and the omission of a material fact necessary to make statements not misleading are both specifically declared actionable.

Under Section 18(a) of the 1934 Act, liability is imposed upon any person who makes or causes a false or misleading statement to be made. Under Section 11 of the 1933 Act the specific persons are named (issuer, directors, experts, underwriters, signers). It is suggested that under Section 18(a) the burden of proof is on the person instituting the action to show that he relied on the statement and suffered loss, not knowing that the statement was false or misleading, whereas, under Section 11 of the 1933 Act, the burden is on the defendant.

These provisions in the two Acts impose responsibility on the independent certified public accountant signing the statements to be filed with the Securi-

ties and Exchange Commission to require the accountant to institute supplemental auditing procedures for the discovery of events occurring between the balance sheet date and the effective date of the statement. Because the effective date in such instance may be later than the date on which the engagement is completed, or later than the date of the accountant's report and opinion, it is frequently necessary to institute steps for the discovery of such later events and to consider the manner in which they should be disclosed.

The steps that are generally taken under such circumstances include a review of the latest interim unaudited financial statements of the company and inspection of the corporate minutes; a review of entries in the General Journal, Voucher Register and Cash records, all for the purpose of discovering unusual items of material amount in order that information and explanations concerning them may be obtained.

In addition to the foregoing the independent auditor should make inquiries from responsible executives and departments, including the President, Comptroller, Treasurer, legal, contract, insurance, purchasing, sales and personnel, and, where considered necessary and practicable, obtain written representations from them.

At this point it may be well to emphasize that one would not expect developments disclosed by the measures outlined above to give rise to adjustments of the financial statements at the balance sheet date, as the normal auditing procedures outlined by Mr. Siegel should have disclosed these. It is expected, rather, that the events disclosed will be such as would later be found in an examination of the accounts for the subsequent fiscal year. If there are any such developments, the independent auditor and the reporting corporation have two courses open to them. The information may be disclosed by the corporation in notes appended to the financial statements or, in the case of a registration statement, in the textual material forming part of the statement. If a difference between the management and the independent auditor exists concerning the form or content of the disclosure, the independent auditor may be forced to consider the necessity for remedying the defect through appropriate explanations contained in the report and opinion.

Events which may be required to be reported fall into two general classifications, namely, those as to which monetary estimates are possible and those affecting the future financial position of the company which are not susceptible to financial measurement. Examples of the first type include such events as fire losses, acquisitions or sales of important productive facilities, changes in capital structure, damage suits, etc. Of course, the test of materiality should be applied in respect of each item. Examples of developments in respect to which monetary estimates as to their future effect cannot be made include new inventions giving rise to obsolescence of products or facilities, important changes in management or labor relations, important changes in statutes, etc.

Frequently underwriters require independent auditors to express written opinions concerning the existence or non-existence of supplementary developments of the character I have been discussing. Extreme care is required in expressing such an opinion. Usually the accountant can do no more than to recite the facts, state the source of his information and make it clear that the events occurred in a period which was not audited.

The accountant's report and opinion at the balance sheet date, if supplementary events are fully disclosed in footnotes, need make no reference to them. If the auditor is not satisfied with the disclosure made, or in the absence of any disclosure, he may be required to make mention of that in his report and opinion. In such instance his responsibility is limited, in my opinion, to a recital of the facts, and

he should use extreme care that he does not express or imply an opinion as to the effect of supplementary happenings not measurable in dollars.

Sometimes the accountant finds himself forced to consider the disclosure of supplementary events of a favorable character as well as those of an adverse nature. I am of the opinion that the obligation for disclosure of both exists. However, one can be certain that criticism will fall more heavily on the auditor who fails to disclose adverse factors, and for this reason it is natural that our supplementary investigation is pointed more toward those things which might harm the company's future.

Tax Aids via Elmira

By J. K. LASSER, C.P.A.

YOUR editor cautioned me to make liberal notes upon the important things said at a two-day tax meeting of the Society held at Elmira, in May. Here is the record of a bit of the material that served to leave lasting impressions with me. Much of it was tremendously worth clipping. All of it is the result of the highly specialized research and experience of a gallant band of tax students. The speakers and the subjects at Elmira were:

BENJAMIN GRUND—How to conduct transactions in business that involve husband and wife and other members of the family.

MAX ROLNIK—Elections in the income tax law and regulations that give you tax reductions.

MAURICE H. RICH—What to think about in planning for the estate taxes due by a business man upon his death.

MILTON C. CHARLES—How to use accounting methods and accounting periods to get the greatest tax advantage.

MAURICE AUSTIN—How to conduct personal holding companies to avoid the penalties in the law.

JOHN P. WILLIAMS—How to handle the income and deductions of controlled companies.

PAUL D. SEGHERS—How to do business outside the country and how a foreign company should do business here.

GLENN O. WILLIAMS—How to make compensation arrangements today in light of the most recent decisions.

A. E. SURDAM—Discussion of the methods used in determining stock, real estate and goodwill valuations for income and estate tax purposes.

V. H. MALONEY—How to organize a business to get the best possible form.

J. K. LASSER—How to reorganize a business to get greater tax advantages than exist in the present form.

LESLIE MILLS—Planning for the business income and expenses to get the best tax advantage.

SAMUEL SINGER—What is new in depreciation, depletion, abandonment and amortization problems.

Here, now, is what we caught as we ran along with the taxfeast. This is simply a bit out of each man's talk. It is expected that some of them will be printed in full in future issues.

J. K. LASSER, C.P.A., holds certificates from the States of New York, New Jersey and California. He is Chairman of the Committee on Federal Taxation of the Society and a member of the corresponding Committee of the American Institute of Accountants. He is also Chairman of the Institute on Federal Taxation at New York University.

He has written extensively and is the author of *Your Income Tax, Your Corporation Tax*, the *Business Tax Guide*, the *Business Executive's Guide* and a host of articles, principally on tax matters. He is also the editor of the *Handbook of Accounting Methods*.

He also conducts *The Tax Clinic*, a regular monthly column dealing with current tax matters in *The Journal of Accountancy*.

Grund on Partnerships

Despite the partnership decisions Grund said it was still possible (in New York) to get effective assignment of a lot of family income by

1. Tenancies by entirety, *or*
2. Buying property in *both* names—even if the husband puts up *all* the money.

These afford as much relief (in many cases) as the old partnerships. This argued Grund, is unanswerable, in the light of the partnership decisions.

Apparently the government is not going into the Supreme Court with partnership cases that it is losing in the Circuits—even though the Circuits are revising the present harsh rules in the Tax Court. This is particularly true of joint venture cases, as distinguished from partnerships. *Collector* v. *Beazley*, 157 F. 2nd, 970 (CCA 5); *Collector* v. *Feldman*, (CCA 5) 158 F. 2nd, 448; *Durwood* v. *Commissioner*, (CCA 8) —Decided February 6, 1947; and District Court decisions.

In view of the present trend of incorporations of partnerships, Grund suggested—

1. Liquidation of partnership with distribution of investment assets such as real estate, securities, etc., to the "inactive" partners. Then continue the partnership with only active partners as members and have the corporation rent the assets for use by the new partnership.
2. In incorporation be sure to avoid the situation that was present in *Overton*, 6 TC 304, to insure that dividends are taxed to the inactive partners. (Consider preferred stock only for such partners as alternative.)

Rolnik on Income Tax Elections

Rolnik developed something we had long hoped someone would do—a check list of the alternatives of the law and regulations that give you tax reductions. The entire list is important and ought to be reprinted somewhere. We can include only part of it here and hope someone else gets out a full listing. He divided the elections into—

Basic methods available for deriving income, such as:

Investments in income not taxed at all—e.g., municipal bond interest or property giving unrealized appreciation; income taxed only in part—e.g., dividends received by corporations; income taxed at lower rates—e.g., long-term capital gains; such as income earned outside of U. S.—e.g., earned income from foreign countries.

Methods of handling transactions to get the lowest tax, such as:

Selection of property to be sold which gives lowest tax; getting into recognized or non-recognized gains and losses; dealers and non-dealers, etc.

Methods of timing transactions, such as:

Short-term and long-term capital gains and losses; obtaining full benefit of carry-overs; income earned over longer period, etc.

Allocating the income and deductions to get the greatest benefit, by:

Assignments of income or property or gifts; or creation of one or more trusts; or family partnerships; doing business as individual, as partnership, as one or several corporations, etc.

Selecting the best method of reporting income using advantageously all sections concerning:

Valuation of inventory; intangible drilling costs; carrying charges; amortization of bond premium; accrual of interest on government bonds by cash basis taxpayer; recovery of unconstitutional Federal taxes; foreign income tax, credit or deduction; accrual by cash basis taxpayer; cancellation, reduction, retirement or redemption of indebtedness provided basis of property is reduced, etc.

Making the best elections at the date of filing a return, such as:

Computing net income by separate or joint returns of husband and wife; or by using the standard deduction advantageously; or by taking the installment method on profit on casual installment sales of personal property and sales of real property, etc.; computing the tax by using the optional tax computation for individuals, or the alternative tax on capital gains, or taking the credit for foreign income tax, etc.

Choosing the way to make payment of tax, such as using:

Installment payment of tax; extensions to pay tax; extensions where carry-back is anticipated, etc.

Rich on Estate Planning

We thought the Rich compilation of methods of various estate planning to be of major importance. That included the methods of minimizing the estate tax by transactions during lifetime of client through:

Life insurance purchased by others, with no incidents of ownership by client.

Gifts to family directly or indirectly in trust but avoiding, if possible, taxability under the doctrine of "contemplation of death."

Eliminating from the client's property of income-producing property which builds up the estate.

Discussing the method of providing funds for payment of estate taxes and administrative expenses, Rich pointed out that the mechanics should include arrangements during the lifetime of the decedent, as follows:

Through life insurance payable to estate. (But subject to estate tax).

By contract for sale of interest in business on death, to key employees, partners or shareholders, etc.

By business insurance trusts providing funds for sale of business interests at death.

Preservation of estate involved, too, the need to avoid successive estate taxes on deaths of beneficiaries by

Granting life estates and remainder (within rule against perpetuities).

Granting powers of appointment which qualify as tax free by statute.

Testamentary trusts; but in these try to avoid the taxable invasion of corpus.

Charles on Accounting Methods and Periods

Discussing down to earth accounting methods Charles noted these tax aids:

Two businesses owned by an individual may have different accounting methods—one cash and one accrual.

Fiscal (not calendar) year accounting is not possible unless actual books are kept on that basis.

Thirteen week reporting period means you have *not* elected a fiscal year—even if this reporting method has been used for a long time. You may be converted to a calendar year by the Bureau.

Election of accounting methods on a first return is very important—for example, real study should be made of: the methods of defining income by postponing passing of title (via consignments or similar deals); deferring or including expenses.

Constructive receipt rules do not mean that you can assume constructive payment giving you a deduction—the Tax Court holds otherwise.

Filing a refund claim for tax does not bar a deduction. A contest denying the tax will prevent a deduction.

The installment basis is only permissible where there is a gain.

An architect cannot get the benefit of long term contract accounting.

Austin on Personal Holding Companies

In some cases, Austin pointed out, the Personal Holding Company status is desirable because:

1. Highly favored treatment gives net long term capital gains. If you are worried about 102—you change over to this status.
2. Net long-term capital gain in the case of a Personal Holding Company is subject only to a 25% tax with no further tax for non-distribution thereof — in other companies, payment of 25% tax does not avoid application of section 102 to the long-term gain.
3. Favorable rule for charitable contributions—For purpose of Personal Holding Company tax, contributions are allowed up to 15% of net income (modified somewhat for this purpose), including net long-term capital gains—for purpose of section 102 tax on non-personal holding companies contributions are allowable without limit.
4. Rule in capital loss—For purpose of personal holding companies tax, capital loss deduction is limited, with five-year carryover, in the ordinary way—for purpose of section 102 tax, capital losses are deductible without limit, and loss carryover not applied. (Possible double deduction in case of change of status from ordinary corporation to personal holding company). Same loss allowed for 102 purposes can be carried forward and allowed as a deduction for the Personal Holding Tax.

How do you alter the gross income ratio when you find yourself likely to

be subjected to the tax? Austin's aids are:

1. Remember that all costs of goods, property, or purchased services sold are to be deducted from sales proceeds—e.g., manufacturing overhead, farm expenses —to find your gross income.
2. Try to purchase real estate with small equity and high gross income.
3. Use the installment basis—rather than including full gain in sales.
4. Take gains on real and depreciable property—they are not personal holding company income.
5. Take losses on securities whose gain is included. Losses do not reduce Personal Holding income.
6. Take reimbursement of expenses from related companies. This is not gross income. That is not true of compensation for services rendered or rent for facilities provided.

Some difficulty is had with the method of computing the 25% tax. Austin pointed out that it is to be computed this way:

EXAMPLE: Assume a company has a net long term gain of $80,000, other net income of $50,000, and dividends to stockholders of $9,000. We would compute the tax this way—

Income	
On ordinary income.......	$ 19,000
On long term gain.........	20,000
Total Income Tax....	$ 39,000
Personal Holding Company's Net Income	
Net income...............	$130,000
Less: income tax..........	39,000
	$ 91,000
Less: distributions to stockholders	9,000
	$ 82,000
Net long term gain........	80,000
Balance	$ 2,000
Tax	
Personal Holding Company tax on balance @ 75%..	$ 1,500
25% tax on long term gain	20,000
	$21,500
25% tax on long term gain paid on form 1120	20,000
Personal Holding Company's Tax...	$ 1,500
Total Income and Personal Holding Company Taxes..	$ 40,500

J. P. Williams on Controlled Companies

The principles laid down by the decided cases were briefly summarized by Williams, as follows:

Under Section 45 the Commissioner cannot require taxpayers so to arrange their affairs as to produce the largest conceivable tax liability.

The taxpayer has the burden of showing that a Section 45 determination is an abuse of the authority granted to the Commissioner. The taxpayer has the burden of establishing a more accurate allocation.

The Commissioner cannot arbitrarily set up income where it does not exist, nor may he use Sec. 45 to disallow deductions entirely.

The Commissioner can only allocate income and deductions. He cannot aggregate the net income of controlled businesses and tax them as a unit.

Where it is determined that the transaction between controlled taxpayers was not "at arms length", the usual method of reallocation is to substitute the fair market value at the date of the transaction for that carried on the taxpayer's books. If fair market value is used by the taxpayer, there is no basis for the application of Sec. 45.

Adjustments under section 45 should not be made under the consolidated returns provision. Specific intercompany accounts should be consolidated solely for the purpose of making an accurate distribution of profits so that a separate net income and tax may be computed for each company. There should be such an analysis of the accounts as to make it possible to attribute to each trade or business the gains, profits, etc. properly belonging to it. Intercompany items such as dividends, interest, sales, etc. are not to be eliminated as in a consolidated return but merely adjusted so as to correctly reflect the separate income of each company.

Williams noted that the Regulations go beyond the authority granted by the statute particularly in providing that "the standard to be applied in every case is that of any uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" and that the income of the controlled taxpayer must be the Commissioner's interpretation of what it would have been had

the parties been strangers to each other. But, says Williams, the courts have restricted the application of section 45 to cases where tax evasion or intermingling of accounts occurs. They have not permitted section 45 to be used to disregard the actualities of business transactions in order to arrive at largest conceivable tax liability. There are, of course, circumstances in which the Commissioner may disregard the form of the transaction, ignore corporate and other entities, and the like. But he is obliged to proceed under other sections of the Code. He cannot justify the action under section 45.

Seghers on Foreign Trade Problems

Paul Seghers covered a lot of the material he used in his article in the March issue of this magazine, which we shall not repeat. But a couple of other jottings were important:

Where foreign currencies of fluctuating values are involved, the determination of the amount of income subject to United States income tax, and the time when such income is realized, present many problems and, consequently, many opportunities for tax savings.

The first step toward wisdom in this direction is to realize that foreign currency does not constitute *money* for Federal income tax purposes, but other *property*. For Federal income tax purposes there is no such thing as a *sale* of property for foreign currency; no purchase for foreign currency; no *payment* of a debt in foreign currency. Every such transaction constitutes, for such purposes, an *exchange* of property for property. Keeping this in mind will give a better understanding of the tax effect of the infinite variety of transactions involving foreign currencies and foreign exchange. For instance, the courts have consistently held that the borrowing and repayment of foreign currency do not, in themselves, result in taxable income, despite a lower exchange rate for the foreign currency, expressed in United States dollars, at the date of repayment. It is necessary to think of such a transaction as a purchase of *property* and the return of the same *property*.

There are many other less-known tax saving opportunities in connection with other features of foreign trade and income from foreign sources.

The possibility of obtaining refunds with respect to dividends and patent royalties from British sources is of timely interest. Such refunds may result from the tax convention between the United States and Great Britain, ratified in 1946 but retroactively effective to various dates at least as far back as January 1, 1945, depending on the facts in the particular case. Such tax refunds, in the case of patent royalties, must be claimed and obtained by U. S. taxpayers from the British Treasury, whereas tax refunds on account of dividends are to be claimed from the U. S. Treasury.

Refunds on other grounds likewise may be obtainable as a result of the enactment of this tax convention. In addition, where credit against United States income and excess profits tax on account of British taxes on patent royalties has been denied for years prior to 1945, there would still appear to be some possibility of obtaining refunds for years not yet outlawed.

G. O. Williams on Salaries

Here is a list Glenn O. Williams prepared to show the results in all the recent cases:

SALARIES ALLOWED BY THE TAX COURT

Type of Business	Tax year	Sales (000 omitted)	Net Profits After Officers' Salaries (000 omitted)	Dividends Paid (000 omitted)	No. of Officers	Salaries: Deducted for these officers	Salaries: Allowed for these officers
Manufacturer of electrical heating equipment	1941	222	41		1	$ 56,000	$ 40,000
Industrial engineering	1941	87	11		1	19,000	19,000
Automobile sales and repairs	1942	248	6		2	23,000	18,000
	1941	653	12		2	29,000	18,000
	1940	553	7		2	21,000	15,000
Manufacturer of soft drinks	1943	133	1		2	24,000	16,000
	1942	117	7		2	18,000	16,000
Lumber and steel dealer	1941	2,000		(6% on all stock)	1	45,000	45,000
Manufacturer of machines and tags	1941	669	295	("Substantial" amounts)	2	72,000	72,000
Engineering construction	1940	2,700	312	50	2	200,000	120,000
	1938	1,700	223		2	200,000	120,000
Coal mining	1941	3,000	31		3	64,000	25,000
Building construction	1941	2,900	28		1	50,000	25,000
	1940	1,600	48		1	50,000	25,000
Marine construction and dredging	1941	18,900	466		2	126,000	96,000
	1940	4,900	228		2	73,000	59,000
Manufacturer of steel castings	1942	1,900	289	22	4	124,000	99,000
	1941	1,300	177	20	4	117,000	91,000
	1940	700	61	9	4	63,000	63,000
Cotton goods converter	1941	5,800	196		4	94,000	71,000
Manufacturer of tin cans	1941	179	28		4	27,000	22,000
Broker and shipping agent	1941	3,000		60	2	141,000	120,000
Processor of meat sausages	1940	252		4	3	45,000	33,000

Surdam on Valuations

Particularly useful as a check list was Surdam's suggestion for more usual methods of ready valuation.

For Stock Valuations—use:

- Quoted or established market transactions.
- Book equity values.
- Appraisal equity values.
- Capitalized earning value.
- Established operating and dividend policy.
- History of management.
- A combination of two or more of the above factors.

For Bond Valuations—use:

- Quoted or established market transactions.
- Book equity values (limited by redemption or call values).
- Yield—as compared with similar bonds having an established market.

For Real Estate Valuations—use:

- Comparison with similar properties on which a record of sale exists.
- Comparison of assessed value with sale price and assessed values of other properties in the same district.
- Established earning power.
- Plottage and availability for special use.

For Goodwill Valuation—use:

- Established earning power over a reasonable return on tangible assets used in the business. Remember that goodwill is usually the measure of earning power in *excess* of a normal return on tangible assets employed in the busi-

ness. It is the measure of the excess of fair value of stock over the net value of tangible assets. It may be lost by change in management or in control of a business.

Monopolistic rights created by the goodwill or the properties from which the goodwill stems.

Limitation of life, or of market, or of use of factor of goodwill.

Surdam pointed out that the State of New York usually determines the value of stock of a closely held corporation by using the average between the net book value and an earning value based upon 8 times (i.e. @ 12½%) the average earnings for a period of three years.

Discussing excessive or prices paid on inventories today — premiums or bonus deals, (so prevalent today), Surdam wondered whether the Bureau would permit the excess (over normal price or list price) to be included in year-end inventories. So do we.

Maloney on Organizing a Business

On the argument of a proprietorship versus a corporation, Maloney urged these points not usually covered—

The advantage of a corporation may be denied by the Commissioner if he finds that it was a "collapsible corporation."

If the owner is also employed by the corporation, he may have to draw a salary in loss years in order to justify its reasonableness in other years. Thus, he will have taxable income although business does not show a profit. If the business fails, a loss on the stock will be a capital loss, which is deductible only to a limited extent.

For the corporation he indicated that there are these advantages:

The owner will have a capital gain when corporation is liquidated.

The owner may be able to liquidate in a year when he has losses to offset the gain from liquidation.

If the owner dies, his estate can liquidate with no income tax because the value of the stock will be its basis.

A new corporation is a new taxpayer and can choose its fiscal period, accounting methods, etc.

When you start up—urged Maloney—think of these points in setting up the business and its accounting methods:

A corporation or partnership may end a first year before twelve months have elapsed and thus keep its income out of higher tax brackets.

Choose the proper accounting period. This will avoid the necessity of obtaining permission to change the period.

If there are inventories the taxpayer will be bound by the election in its first return as between cost and cost or market, whichever is lower. The latter is usually more advantageous.

The taxpayer will be bound by its choice between the method of deducting specific bad debts and deducting reasonable additions to a bad debt reserve.

Within reason almost any method of depreciation can be selected. But in later years no change can be made without the Commissioner's permission. Of course, the method selected must produce no more than a reasonable amount of depreciation.

Mills on Business Planning

Particularly important were the notes Mills made on how to reduce the tax of a business by watching the many points he listed. Some are briefed here —just sufficient to get over the idea of what to look for for your record.

Merchandise shipped on approval or subject to acceptance is not "sold" until accepted or approved.

Consignment sales may be used to defer time of taxation of profit.

Cash discount versus trade discount or price reduction as means of control of time of taxation of profit.

Advance payments for rentals or services to be rendered in future—postpone unless current year is unprofitable.

Retirement of obligations at discount—negotiate *directly* with creditors.

Accrual of income which is doubtful of collection—avoid when doubt is real as future write-offs may have little tax advantage.

Trade in of assets—should you avoid recognition of gain with resulting reduction of basis of new asset, or pay tax on gain (at 25%) and have higher basis for depreciation deductible from ordinary income?

Control of recognition or non-recognition of gain on liquidation of subsidiary by compliance or non-compliance with statutory rules.

Full utilization of sec. 117(j)

- If profits and losses on sale of assets can be placed in different years, taxes may be saved.
- If profits and losses cannot be placed

in different years, consider abandonment instead of sale.

Income from damage suits—arrange in advance for specification of amount which is recovery of capital or for injury to good will, to eliminate these elements from income.

Tax benefit rule—consider application to all refund items. Consider distribution of appreciated property as dividend in kind to avoid taxable gain to corporation.

Possible avoidance of sec. 102 tax by realization of capital gains with resultant classification as personal holding company.

If treasury stock is to be reissued—if possible retire treasury stock and issue new stock to avoid possible income on sale of treasury stock.

Make charitable contributions in appreciated property—full deduction allowed but no gain to donor.

Profit on sale of assets may be postponed by contract to sell rather than contract of sale—option may be given at a price.

Write off all possible worthless or partially worthless debts currently if year is profitable. Recoveries may be taxed at lower rates. Also it may help establish proper year of deduction.

Control of year of taxable income by sale of installment obligations.

Have you any life insurance acquired for valuable consideration? It may be advisable to replace it with new insurance.

Singer on Depreciation

Residence property depreciation is an interesting subject:

If residence property is converted to business use, depreciation is allowable from the time of the conversion and is based on its value at such time. (*Heiner v. Tindle*, 276 U. S. 582, 48 S. Ct. 1929, 326.) But the basis for depreciation may not be greater than cost.

In the case of a subsequent sale of such property, its cost would be reduced by the "allowable" or "allowed" depreciation (whichever is greater) during the time that it was held for business use.

Depreciation may also be allowable on an inherited residence which remained unoccupied after the death of the decedent and was listed for sale or rent at that time. This was allowable even though no tenants were found. (*W. E. Buck*, Memo T.C., 7/8/43.)

(*Ed. Note:* Mr. Lasser modestly refrained from briefing his own remarks on "How to reorganize a business to get greater tax advantages than exist in the present form". Those readers who are interested in them will find them reported in full in 25 *Taxes* 5.)

Some Accounting and Tax Problems of Land Development Companies

By Newton D. St. John, C.P.A.

There has been very little activity on the part of land subdividers since 1929 because of the lack of market demand for building lots. Most of the subdividing of land in recent years has been done by builders who have not attempted much in the selling of lots without building on them.

Up to the end of the recent war people who had desires to build individual homes had little trouble in finding building plots. Since the war many of the available plots have been purchased by prospective home builders and speculators. As the result there may soon be a market for well located subdivision properties, and accountants may again be called upon to provide records and solve some of the problems arising out of the laws and regulations governing the sale of lots.

The author of this paper, Newton D. St. John, has specialized in real estate accounting and related tax problems as a Certified Public Accountant in Florida and in New York. For several years Mr. St. John has served as Comptroller of Bing & Bing, Inc., and its associated real estate and hotel owning corporations. He is a member of our Society and of the American Institute of Accountants, and was one of the early members of the Florida Institute of Accountants. He holds a B. S. degree from the University of Florida, and a Master's degree in Accounting from Columbia University.

This paper was presented at a technical meeting held April 24, 1947, under the auspices of the Committee on Real Estate Accounting, of which Mr. St. John is a member.

As you know, many frauds were perpetrated by land subdividers in the debacle of the 1920s, and to prevent a recurrence many states have passed special laws relating to the subdividing of land. In addition there are the federal laws against using the mails to defraud, under which many irresponsible developers have been prosecuted. Furthermore, most cities and counties now have special regulations applying to the subdividing of lands and the filing of maps, which also have to be observed before lots can be sold.

Accounting Problems

I would say that the first major problem facing the accountant engaged by a developer, would be to install records and to outline the handling of funds and sales contracts to meet the requirements of the laws of the locality and state. To do this the accountant must study all the data relating to the proposed development including, among other things, the following:

1. The partnership or venture agreement; or if a corporation, the articles of incorporation.
2. Regulations and laws of the State and local governments relating to subdivisions; or extracts of them, as they apply to the proposed subdivision, furnished by the developer's attorneys.
3. The documents, minutes, etc., pertaining to the purchase of the property and all papers connected with the financing of the project. These include:
   - Deeds
   - Certificate of title, or policy of title insurance
   - Copies of mortgages or trust deeds

Copies of offset statements and release clauses from owners of mortgages and trust deeds

Copies of financing agreements or notes given banks and others, covering development costs, etc.

Tax receipts and details of assessments.

4. Proposed plans and papers relating to the improvement and sale of the property. These include:

   Map of development

   Engineers' plans and specifications

   Contracts let for the improvements

   Agency and salesmen's contracts

   Copies of contract of sale or lease, and deed and trust deed to be used to convey property to purchasers

   Proposed price list

   Literature to promote sales

5. Copies of statements required by law, and filed by the subdivider with the state and local governments. In New York State, for example, such a statement is required in great detail to be filed with the Department of State, Division of Licenses, Form 573, under Section 337-a of Article 9A of the Real Property Law for vacant lands to be sold on the installment plan. The Department of State has issued regulations governing the sale or lease of such subdivided lands and the acts of the developer are subject to investigation and, if illegal, severe penalities are provided for him as well as any guilty employees.

You will be interested to know that Form 573 for New York requires "financial statement of owners and/or selling agents" to be attached before it is acceptable to the Department of State. There are also requriements as to the handling of money as trust funds and for notifying the Department of State as to any change in the financial structure of subdivided vacant lands offered for sale or lease after the filing of Form 573.

Income Tax Problems

Probably the next most important problem is to determine the most advantageous method of handling costs and sales for income taxes. This is familiar ground to the accountant, so I will mention only a few technical points in this connection.

Regulation 111, Section 29.22(a)11 of the Federal Regulations provides the method for reporting profit or loss from the sale of real property in lots, as follows:

> "*Sale of real property in lots.*—If a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the cost or other basis shall be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels which constitutes taxable income may be returned as income for the year in which the sale is made. This rule contemplates that there will be gain or loss on every lot or parcel sold, and not that the capital in the entire tract may be recovered before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction, and gain or loss computed accordingly."

It has been the practice of subdividers in the past to begin sales of the lots before development is completed or even before development is begun. To comply with the regulation in such a case estimated costs of improvements, in addition to the actual land cost, must be set up on the books. This is done by a series of

reserves and cost of development accounts.

The cost of the land is charged to the real estate account. The estimated cost of developing the land is also charged to the real estate account and credited to a reserve account, which can be called "Reserve for Development". Such an estimate, to stand up, should be based on a report of a competent engineer or on actual contracts let for the work to be done.

In large jobs the "Reserve for Development" account becomes a controlling account in the general ledger for a subsidiary ledger containing a separate account for each contract or type of work, such as grading, paving streets, water mains, curbing, utilities, landscaping, etc. The "Reserve for Development" account actually is a liability account, for as soon as sales begin the subdivider is committed to make the improvements he has represented to the purchasers.

As payments are made for the development work they are charged to a "Cost of Development Account". In a large project, this account likewise becomes a controlling account in the general ledger for a subsidiary ledger containing a separate account for each contract or type of work corresponding to the accounts in the "Reserve for Development" ledger. As each contract is completed the total debit balance in the account in the cost ledger is transferred to the corresponding account in the reserve ledger. The resulting debit or credit balance in that account in the reserve ledger is then transferred to a general account opened in the reserve ledger. When all the contracts are completed the balance in such general account represents the error in the estimates of the cost of the development. This balance can be disposed of by debiting or crediting the real estate account and adjusting the cost of the unsold lots.

The real estate account set up in this manner reflects the entire cost of the lots to be sold. The regulation provides that the cost "shall be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer". The method generally followed is to make a tabulation in a sales book of all the lots at the sales or offering prices, and then to apportion the total cost to each of the lots in proportion to its sales price to the total sales price of all the lots. As the proposed sales price takes into account location, size and other factors of relative value, this method is deemed equitable under most conditions.

Lots in subdivisions are generally sold on contract in some form where the purchaser makes payments in installments and in many cases receives a deed to the property only when the entire purchase price has been paid. These contracts are usually accounted for through the medium of a contracts receivable ledger or card record, similar to the ordinary accounts receivable ledger, with a controlling "Contracts Receivable" account in the general ledger.

Due to the fact that the contracts' receivable usually are payable over a period of two or more years, the subdivider can take advantage in some instances of the provisions of the federal income tax law that pertain either to the sales of real property on the installment plan or the deferred payment plan. These provisions are set forth in Regulation 111, Section 29.44-3 or Section 29.44-4.

On the installment plan the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price. If the property is repossessed the vendor realizes gain to the extent of the fair market value of the property at that time (including the fair market value of any fixed improvements placed on the prop-

erty by the purchaser) just as if he had received cash.

It is not permissible to report sales of real estate on the installment plan where the cash payments in the year of sale exceed 30 percent of the selling price. Such a sale is classified as a "deferred payment sale — not on installment plan" for tax purposes. In such a case the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the extent of their fair market value in ascertaining the profit or loss from the transaction. The vendor may use the "deferred payment plan" for any sales for which he has not elected to use the "installment plan".

The regulations provide that if the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis provided above and the amount realized therefor.

The regulations on deferred payment sales close with these words "Only in rare and extraordinary cases does property have no fair market value." I will, therefore, close this article with my own observation that nothing can be as worthless (and easier to prove so by means of testimony and affidavit) as the uncollected contracts from sales in land subdivisions, once the market begins to go sour and the purchasers are demanding their money back.

The Allowance of Rentals as Tax Deductions

By HENRY L. FLEISCHMAN, C.P.A.

THE late Theodore Roosevelt coined the phrase "weasel words" before the first income tax law was written. Could it be by way of pre-vision that he contemplated the artless phraseology of that portion of Section 23 (a) of the Internal Revenue Code, dealing with the allowance of business rentals?

Section 23 starts off with the phrase:

> "In computing net income, there shall be allowed as deductions."

It then drops down to paragraph "(a)" bearing the single word "Expenses", following which is a long dash, the numeral "(1)" and the words "Trade or Busines Expenses", another dash and then sub-sub-paragraph "(A)" and the words "In General". Then follows a single lengthy sentence starting off with:

> "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

Way down at the end we find a semicolon. Please note that semicolon because it might be important. After the punctuation mark we reach the meat in the coconut, finding:

> "Rentals or other payments required to be made as a condition to the continued use or possession, for purposes of trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Two serious questions arise which can bedevil innocent taxpayers and we should be on guard concerning them.

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In the absence of Mr. Fleischman, this paper was read by Mr. W. Vincent Hall, Chairman of the Commitee on Real Estate Accounting, at a technical meeting held on April 24.

I—The Wandering Semicolon or Must Rents Be Reasonable?

It has been pretty generally assumed that rentals for business property must be "reasonable." This has been taken for granted from the balance of the sentence speaking of all ordinary and necessary expenses * * *, including a reasonable allowance for salaries, etc. A bold taxpayer, however, when its deduction under a percentage rental was attacked started to study English grammar; his was the case of *Imerman v. Commisioner*, 7 T.C. 1030, where brothers operating as a partnership rented from their mother premises under a percentage rental, with a fixed minimum. Rent deducted for the year exceeded $33,000, of which the Commissioner allowed only $12,000 as reasonable, holding that the balance was a mere family arrangement. The Court surprisingly sustained the taxpayer on the ground that the Code did not limit rental payments to a reasonable allowance, as in the case of compensation; nothing in the schedule of rents suggested a gift and consequently the full amount paid was allowable under the statute.

Up to that point the Commissioner had fairly easy sailing. Practically all of his cases resulted from facts where there existed some community of interest between landlord and tenant.

He was bound to be successful because he could always pin his general attack on the theory that the payments were in fact not rentals in their entirety but rather a mode of distributing profits. Thus in *Hughes and Hatches* v. *Commissioner*, T.C. memo op. April 6, 1945, Dkt. 2549, a minimum plus a percentage of sales rental was sustained on evidence that such rental was in line with what other similar businesses in the area were paying. In *Monnah Park Block Company* v. *Commissioner*, T.C. memo op. April 20, 1945, Dkt. 3263, taxpayer rented five trucks at $75 a month, and real estate at $100 a month, from its controlling stockholders. The Commissioner contended that the charges were excessive and disallowed them in part. As to the trucks, the taxpayer was sustained on evidence that the rental was lower than the usual charge by truck owners in similar operations. The realty rental was found to be excessive on the grounds that the property was purchased during the year for $1,248 and a non-excessive rental was allowed of $66.67 a month. Similar holdings, involving community of interest between landlord and tenant, are reported in *Charlie's Cafe Exceptionale, Inc.* v. *Commissioner*, T.C. memo op., Dkt. 7465, and *Limericks, Inc.* v. *Commissioner*, 7 T. C. 1129.

Frankly, under the present state of the law, there is no way of determining whether rents must be reasonable to be allowable, assuming that the parties are dealing at arms-length. For the open years and a relatively short time to come, this question may be very significant. However, from a long range viewpoint, it seems inevitable that the deduction for rentals will be limited to a reasonable amount.

The question of reasonableness, when rents are considered, is inextricably interwoven with the concept of time, particularly where long-term leases are concerned. If a rental is set when property values are high and business is good, will the same rental be reasonable during the depths of a depression? Should the full rental reserved under an improvident lease, entered into because of an error in business judgment, be allowed as reasonable?

A number of retail store locations have been financed under an arrangement whereby fee title is conveyed to a financial institution and simultaneously the store enters into a lease, yielding the institution a level net rental which is calculated to retire the purchase price and interest on unpaid balances over a predetermined period. A number of states have quite recently amended their statutes permitting life insurance companies to invest in this type of project and as a result this method of financing has become a very significant factor in the realty field. It is essential, in this type of deal, to consider whether the rental produced by the formula should and will be reasonable. Obviously, the longer the term of the lease, the more reasonable the rental will be, provided it is computed at a single level. Already, some of the insurance companies are offering "step" rentals, that is for each five years of the term the rental will change, generally downward.

The only statutory measure of a reasonable rental was contained in Sec. 245 (b) of the Revenue Acts of 1921 and 1924 and long since repealed. For the words and music, don't fail to read *Helvering* v. *The Independent Life Insurance Company*, 292 U.S. 371.

II—The Taxpayer * * * Is Not Taking Title * * * or Has No Equity

This constitutes the true nub of the problem being considered here. No deduction is to be allowed under the provisions of the statute for payments which represent part of the purchase price of the property or an equity therein. Just what is an equity?

Mertens concludes as to the meaning of "equity" the following:

> "There has been no satisfactory meaning of the term 'equity' as used in the statute. Its application to specific cases is apt to give substantial trouble." *

* Law of Federal Income Taxation, Par. 25.93, note 26.

In its zeal to corral revenue, the Treasury has gone to great lengths in determining what constitutes an "equity." Thus in *Minneapolis Security Building Corp.* v. *Commissioner,* 38 BTA 1220, there is dicta to the effect that where a security deposit belonging to the tenant could be invested in fractional interests in the fee, such permissive investment would be sufficient to disallow deductions, as rentals, upon forfeiture of such deposit.

One of the early cases, *Jefferson Gas Coal Company* v. *Commissioner,* 52 Fed. (2d) 120, CCA-3 (1930), is indicative. In 1920, taxpayer leased coal mining rights for a rent or royalty of 12¢ a ton, with a minimum rental of $31,000 a year plus taxes. The lease provided that when the aggregate rentals paid reached the sum of $310,000, title in fee to the unmined coal would be conveyed to the tenant for a further consideration of $1. In the case at bar income taxes for the years 1921-23 were in question. The earned rentals, at 12¢ per ton, for the period, were $25,176.72 but the taxpayer was obliged to and did pay the minimum rents aggregating $93,000, all of which it claimed for tax purposes. The court then found:

> "In other words, it (the taxpayer) paid an excess of $67,823.28 and had an equity at least to that extent in the unmined coal."

The court concluded that

> "Looking at the instrument as a whole and the object sought to be obtained, that it is a contract of sale of the coal in place and not a lease is inescapable."

Accordingly, the entire rentals of $93,-000 were disallowed.

In *Holeproof Hosiery Company* v. *Commisioner,* 11 BTA 547, the taxpayer in July, 1921, entered into a lease with Textile Machine Works, whereby it rented stocking knitting machines having a value of $26,650 for a term of thirty months at a rental of $200 per month per machine plus an obligation to insure. The lease provided that within ten days after the expiration of the lease, that is, when $24,000 in rents had been paid, the machines could be purchased by the lessee for $5,677.26; or at the lessee's option, at the end of twenty-four months, when $19,200 in rents had been paid, the machines could be purchased for $9,291.34. The taxpayer ultimately acquired title to the machines, the time of which is not stated. The rental charges for 1921 were placed in issue. The Board held:

> "The evidence in this case indicates that at the end of 1921 the petitioner had a substantial equity in these machines. We do not know the life of the machines but we do know that they were still in use five years after the taxable year in question. We do not know at what amount the machines could be rented on the open market but we know that the total amounts to be paid under the lease agreements before the title to the machines was to pass to the petitioners, exceeded but slightly the stated value of the machines, and it is inconceivable that the petitioner was not acquiring something of value, that is a certain equity in the machines, with each payment made in accordance with the agreement. The courts of Pennsylvania have recognized the existence of such an equity under leases similar to these. *Schmidt* v. *Bader,* 284 Pa. 41; *Packard Motor Car Co.* v. *Mazer,* 77 Pa. Super. Ct. 348; *Edward's Appeal,* 105 Pa. 103. The statute does not allow the deduction claimed."

In *Alexander W. Smith Jr., Exc.* v. *Commisioner,* 20 BTA 27, property was purchased in 1914 in Atlanta, Georgia for $120,000. In 1919, a "lease" of the property was made for a twenty year term commencing November 1, 1919 under which $10 earnest money payment was made and a monthly net rental of $1,000 was reserved. At the end of the term, for $10, the "tenant" was to receive a deed to the property. To assure delivery of the deed, it was executed at the making of the lease and deposited in escrow with an Atlanta bank. Under the provisions of the lease, the "tenant" could be evicted upon default of a single instalment of rent. The Board, citing *Blitch* v. *Edwards,* 96 Ga. 606; *Hays* v. *Jordan,* 85 Ga. 741 and *Lytle* v. *Scottish American Mortgage Co.,* 122 Ga. 458, held:

> "On authority of the above cases the relationship between the parties was not

one of lessor and lessee, but of vendor and vendee; the transaction was a conditional sale; and the $1,000 payments made by Shannon were not rent, but purchase price * * *. The execution and deposit of the deed in escrow further strengthens this view, for the grantor had no control or power over the escrow deed and can no more countermand the delivery thereof than an absolute deed, and it is always in the power of the grantee to entitle himself to the deed and to the estate by performing the stipulated condition, *Wellborn* v. *Weaver*, 17 Ga. 267."

Robert A. Taft v. *Commisioner*, 27 BTA 808, follows a similar pattern. There the taxpayer first made a written offer to purchase realty for $185,000 and then proceeded to alter the deal by entering into a "lease" whereby he was to make "advance payments" of rental over a period of years to the extent of $100,000 and was given the option to purchase at the end of the term for $85,000. The fixed rental was set up to yield 5% on unpaid balances. Evidence adduced at the trial indicated that the "landlord" considered the transaction to be a sale when it was entered into and not a lease. Further evidence disclosed that ownership of a mortgage under Ohio tax law was onerous and therefore it was not unusual to disguise mortgages as leases or other instruments. The Board held that the transaction was, in fact, an instalment sale and no rentals were deductible.

The facts in *Helser Machine and Marine Works, Inc.* v. *Commissioner*, 39 BTA 642, were quite clear cut. The taxpayer entered into a realty lease for a term of ten years from May 1, 1935, at a rental of $1,920 a year. The lease provided that whenever $19,200 was paid in rent a deed would be delivered. It was held that the 1935 payments were not rents but payments on account of the purchase price. The decision indicates that the taxpayer has the burden of proving, in connection with rent deductions, that it is not taking title nor that it has any equity therein:

"Each monthly payment lessened the remainder and eased petitioner's burden. Clearly a lump sum so paid would be the price of a conveyance, and we think that the monthly sums have the same character. It is not necessary to hold that by payment of the rental the petitioner acquires an 'equity', for that word is not easy to define; it is enough that the lease provides a right in petitioner to take title to the property for which the rental is paid."

Probably the most recent case in the books is *Lodzieski* v. *Commissioner*, TC memo op., October 6, 1944, Dkt. 3060. In 1920 a 99 year lease was entered into, containing the following salient provisions: The tenant was to erect a building on the property costing at least $40,000; the tenant had the option to purchase the premises during the term at a price of $70,000 during the first 15 years and at $80,000 thereafter; the rent was $3,900 per annum for the first 5 years, $4,200 a year for each of the next ten years and $4,500 a year thereafter. In 1922 the lease was assigned to the taxpayer. On January 2, 1940, the taxpayer and the owner entered into a modification of the lease under which the rent was reduced to $3,900 a year and by the same instrument, the taxpayer agreed to purchase the property for $24,000, of which $15,000 was paid at signing of the agreement and the balance of $9,000 became due on December 31, 1949. A deed of trust was executed by the owner to a title company.

Considering the claim for rent as an allowable deduction, the Tax Court stated:

"The language of these instruments, coupled with the execution of the deed * * * and the payment of $15,000 on the purchase price, demonstate clearly that it was the intention of the parties to set up a kind of escrow agreement, that the petitioner was in the process of acquiring title to this real estate and that the agreement of January 2, 1940 was in fact a contract for deed. * * * Hence the petitioner is precluded from having a deduction under Section 23 (a) of the $3,900 annual payments made * * * in 1940 and 1941".

All of these cases have one point in common, that is, if the taxpayer has an equity in the property, no portion of the alleged rental payments appear allowable. The statute apparently leaves no place for an apportionment.

Here are a few questions which remain unanswered under the present state of the law:

(1) If a disallowance of rentals is had because the taxpayer is found to have an "equity" in the property, will he be entitled to deduct depreciation or depletion?

(2) Under long-term leases, it is not unusual to accord to the tenant the right to protect his lease by permitting him to make good any defaults of the landlord as to mortgage interest and amortization. Will a payment of amortization under such circumstances be sufficient to bring about a disallowance of the tenant's rental?

(3) If a security deposit of the tenant is invested in mortgage certificates secured in whole or in part by the premises under lease, what is the effect on the allowance of tenant's rental payments?

(4) If a tenant enters a contract to purchase the building from his landlord, does it automatically follow that the rentals paid between the date of the contract and the date of passing of title are to be disallowed?

(5) As to purchase options set forth in leases:

(a) Will the result be any different if the option prices are on an ascending scale, rather than a descending one?

(b) Is it safe to accept an option clause in a lease which provides for a fixed amount to be diminished to the extent of a predetermined rate of depreciation on the improvements?

(c) Is there any absolutely safe predetermined option price which can be inserted in a lease?

Income from Percentage Leases

By JOSEPH JESPERSEN, C.P.A.

MANY store leases contain clauses under which the landlord is entitled to collect as additional rent the excess, if any, of a stated percentage of the tenant's gross sales over the specified minmum rent. It is customary for such leases to provide that the additional rent so determined is to be adjusted from month to month until the end of either the lease year or the term of the lease.

At the end of the landlord's fiscal year, or whenever financial statements are to be prepared, there arises a question as to whether there should be accrued, as income, additional rent based on the percentage of gross sales and, if so, how much.

For instance, a lease for a year ending April 30th may carry provisions calling for a minimum rent of $60,000 a year and additional rent in the amount that 10% of gross sales exceeds the minimum rent, the additional rent based on each month's sales being payable a few days after the end of the month, and being adjusted from month to month to the cumulative excess of 10% of sales over minmum rent. It is suggested that the accounting treatment on the landlord's books may be based on one of three different theories:

(1) That no additional rent should be accrued until the amount of sales exceeds $600,000.

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(2) That additional rent should be accrued from month to month based on the cumulative excess of 10% of sales over minimum rent.

(3) That the amount to be accrued should be based on an estimate of what may be expected from the particular lease.

The first method is based upon a strict construction of the terms of the lease and is the most conservative since it leaves no possibility that additional rent may be accrued on a large volume of sales in the early months of a lease year, only to be offset later by credits based on a small volume of sales. One objection to this first method is that it may involve a distortion of the income as between fiscal periods. For instance, high sales during the summer months might, in the illustration given, bring the year's total over $600,000, but if no additional rent were accrued until sales exceeded that figure, the additional rent would in all probability be accrued in the last month or two of the lease year which ends April 30th, and would thus fall in the following fiscal year. Such distortion of income might be particularly important where the landlord keeps his books on a calendar year and where the tenants have a large volume of Christmas business in December. This first method is likely to be adopted by the landlord only when the minimum is set high so that the additional rent is not likely to be an important factor.

Under the second method, that is, accruing additional rent from month to month based on the percentage of cumulative sales, there arises a possibility that additional rent accrued at the end of the landlord's fiscal year may have to be credited back to the tenant at or before the end of the lease year. For instance, in the illustration given, let us assume in order to simplify the problem that sales in

the first seven months of the lease year, that is May to November, were exactly seven-twelfths of $600,000 so that no additional rent has been accrued. If the December sales rise to $100,000 applying the 10% will result in a total rent of $10,000 for the month instead of the minimum of $5,000. There is no assurance at December 31st that sales in the following four months will be sustained at a level high enough to reach $650,000, the amount necessary to yield $65,000 rent for the lease year. It would therefore be dangerous to accrue any additional rent under the circumstances. But if we assume that sales consistently run high enough from month to month to produce some additional rent each month, there is some warrant for taking into income in each fiscal period the additional rent based on sales in that period. This second method is often preferred by the landlord.

When neither the first nor the second method is deemed applicable, it becomes necessary to resort to the third method. This calls for an examination of the facts as to the particular lease in question. Consideration must be given to volume of the tenant's sales, to their consistency, to seasonal fluctuations, and to any other known factors which may be applicable, such as the prospective opening or closing of a competing store nearby, changes in transit facilities, etc. An estimate must then be made as to whether over the lease year gross sales will be sufficiently high to yield as much adidtional rent as is indicated by applying the percentage to the sales for the expired portion of the lease year.

In order to determine which method should be used it is necessary to give consideration to the factors mentioned relating to the tenant's previous record of sales. Where a tenant has not been operating the store long enough to furnish a sufficient experience record, there is need for a conservative attitude in determining whether any additional rent should be taken into income.

In the foregoing remarks consideration has been given to the effect on the income statement rather than on the balance sheet. Whenever under the terms of the lease there is an obligation on the tenant's part to pay additional rent, the amount thereof should be charged up as an account receivable. Whether the offsetting credit should be reflected in the financial statements in the income account, in a reserve for accounts receivable, or in a deferred credit is a matter which will require the careful consideration of both the landlord and the accountants.

Office and Loft Building Accounting and Auditing

By STEPHEN CHAN, C.P.A.*

A CONSTANTLY increasing number of building owners and managers depend upon accountants for consultation and advice. In order to render constructive service, the auditor should be thoroughly familiar with his client's problems and needs. It is the purpose of this paper to summarize certain accounting and auditing procedures in connection with this type of real estate operation.

Rental Income:

The matter of determining the gross income of a building is relatively simple, since the rentable area is fixed and predetermined and the rental of each unit is expressly set forth in the lease. However, particular note should be made of store leases which often provide for additional rentals based upon a percentage of sales. The building owner's accountant should see that proper sales reports are rendered by the store tenants and should suggest to the owner that store leases provide for an independent certified public accountant's report of sales.

New York, and some other states have passed emergency rent laws limiting the rentals to be charged tenants. The auditor should familiarize himself with these acts to determine that the rentals are within these statutory limits.

Where property is operated by a managing agent, the agent's monthly reports to the owner are generally on a cash receipts and disbursements basis. Even where properties are owner-managed, many owners (especially where small properties are involved) prefer a cash basis for record-keeping purposes.

It may be noted that the present Federal income tax regulations treat rentals received in advance as income when received (even if received for a subsequent year's rental) unless certain restrictions against the use of the funds are present.

Books of Account:

The cash receipts book should be columnarized to segregate rental and other income, and the cash disbursements book, to reflect classes of disbursements.

If sufficient volume exists, a voucher system may be employed for disbursements. Except for very large or complex properties, it is seldom necessary to use a purchase journal; the expenditures are analyzed in the cash disbursement record.

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* Acknowledgment is made of the assistance of Mr. Samuel Caesar, C.P.A., in reviewing the manuscript and suggesting material.

The accounts receivable or rent ledger may contain a page for each tenant, reflecting the lease terms and rent or security deposits, in addition to the usual charges and credits.

In buildings where the charges other than for rent are limited to one or two classifications, the "Boston" type ledger sheet has been found effective.

A model form for an office or loft building is submitted herewith. All tenants' names are listed on the main sheet at the beginning of each fiscal year, leaving two or three spaces between each name for possible changes in occupancy or rentals. The addition of the insert flyleaf sheets (one for each month) results in an entire year's transactions with each tenant being readily available for reference.

A new listing is prepared for each year.

MAIN PAGE

Unit	Square Foot Area	Tenant	Monthly Rent	Lease Term		Special Clauses
				From	To	

INSERT SHEETS

——— Month of 1947 ———

Opening Arrears	Monthly Rent Charge	Other Charges (See legend)		Adjustments (See legend)		Cash Collected	Closing Arrears
		Type *	Amount	Type #	Amount		

SYMBOLS

* Other Charges
E Electricity
T Telephone
R Repair or other service

\# Adjustments
A Allowance
V Vacant
S Security applied

Profit and Loss Statement:

There is no need to discuss the form of general ledger or general journal and, instead of a chart of accounts, there is submitted, herewith, a suggested form of income and profit and loss statement which indicates the various account classifications.

ABC BUILDING CORP.
Statement of Income, Profit and Loss

Income:			
Rents:			
Stores		$ xx	
Upper floors		xx	$ xx
Electricity			xx
Commissions, etc.			xx
Other			xx
Total income			$ xx
Operating expenses:			
Salaries and wages:			
Superintendent	$ xx		
Elevator operators and starters	xx		
Other	xx	$ xx	
Payroll taxes		xx	
Fuel		xx	
Electricity		xx	
Repairs and maintenance:			
Payroll	$ xx		
Building repairs	xx		
Tenants' alterations	·xx		
Supplies	xx	xx	
Cleaning and cleaning supplies		xx	
Uniforms and valet expense		xx	
Insurance		xx	
Management fee	$ xx		
Leasing commissions	xx	xx	
Advertising		xx	
Total			xx
Balance			$ xx
Administrative and general expenses:			
Officers' salaries		$ xx	
Professional fees		xx	
Franchise tax		xx	
Office expense		xx	xx
Balance			$ xx
Real estate tax		$ xx	
Water		xx	
Profit before interest, depreciation and income tax			$ xx
Interest on mortgage			xx
Balance			$ xx
Depreciation			xx
Profit before income tax			$ xx
Provision for Federal income tax			xx
NET PROFIT FOR THE YEAR			$ xx

This statement is preferably presented in comparative form reflecting the period to date this year and last year, as well as the current month's operation and those of the respective month last year.

Type and Content of Auditor's Reports:

In most cases a thorough monthly or quarterly audit and the rendering of a condensed operating or cash statement is to be recommended.

A detailed report may be issued every six months; the form and content of the financial statements depending upon the wishes of the client or the provisions of mortgage indentures. However, the usual semi-annual report will contain a balance sheet and operating statement with supporting schedules and related comments.

The balance sheet should be drawn in the usual commercial form, presenting the current assets and liabilities at the head of their respective side, both for the sake of consistency and because the current positon is as important in the case of a building as in other types of business.

It may be noted that numerous mortgage indentures specify a statement of cash received and expenses paid or accrued which, while a hybrid form, give a conservative presentation of the operating results for the computation of earnings available for interest, sinking fund, etc.

The report may contain comments on:

(a) The percentage of occupancy in dollars and square feet;
(b) A summary of rent arrears divided into tenant in possession and vacated tenants;
(c) The insurance coverage;
(d) Real estate and water tax arrears and the property's assessed value;
(e) Past due interest and sinking fund or redemption arrears on long term indebtedness;
(f) Unusual concessions granted, commissions paid or expense purchases;
(g) The reasons for the larger variations in expenses or income of two comparable periods.

Book value, assessed value and, where available, appraised value should be compared with insurance coverage. (High real estate tax assessed valuations, when compared with the foregoing figures, may disclose grounds for certiorari protest.)

On an initial examination the auditor should analyze and compare the management fee, payroll and the prices paid for fuel, electricity, painting, etc., with the expenditures for like items by other buildings of similar type. Excessive expenditures should be commented upon, perhaps, in a separate letter.

General Audit Suggestions:

The program of audit depends to a great extent upon whether or not there is a managing agent in charge of the property.

When the building is operated by a managing agent the income and expenses may be vouched to the agent's monthly statement. The bookkeeping procedure is also simplified since the foregoing statement may be summarized in journal entry form and posted to the general ledger, thus obviating the need for the purchase journal or voucher register, cash-book and rental or tenants' ledger.

The auditor should verify the accuracy of the leasing and other commission paid; income and concessions should be checked to the lease schedule; and expenditures vouched to bills. The work papers should be drawn up in a form which will reveal duplication of work or charges.

Once or twice a year the insurance policies and capital stock and minute books should be inspected; the outstanding indebtedness confirmed with the mortgagee or creditors; the bank balance confirmed; and the tenants' balances verified by direct means. The

most practical method of verifying tenants' accounts is for the auditor to rubber-stamp the monthly rent statement with a request for confirmation and enclose a stamped, addressed envelope for the reply. At the same date the building should be inspected, in order to verify the vacancies, if any, reflected on the agent's statement.

Audit Program:

A typical program for a monthly or quarterly detailed audit of buildings managed by an agent may be summarized as follows:

Cash:

1. Reconcile the bank balance. (The agent should keep a special bank account for each building managed. Ascertain that collections are deposited promptly in the proper account and audit carefully all outstanding deposits at each bank statement date. Obtain duplicate deposit slips from bank, if outstanding deposits are increasing.)
2. Check the footings of the agent's statements.
3. Summarize the disbursements.

Leases:

1. On a first audit examine all leases and summarize each lease for the work-papers. On subsequent audits examine new leases. Note rental, lease period, security deposit, concessions, cancellation clause, etc.
2. Check monthly rent charges with lease analysis.
3. Compare all new lease rentals with the predetermined rent schedule for the building.
4. Compare each new lease with the expiring lease, comment on important changes.

Rents:

1. Reconcile arrears at beginning and end of period as shown on agent's statement with cash receipts and rent charges. See that the agent's statement sets forth all vacancies and allowances in detail. Comment in your report on any allowances in excess of lease terms.
2. Maintain a running work-paper schedule summarizing arrears and prepayments.
3. If possible, a duplicate copy of each agent's statement should be obtained for the auditors' files.
4. Follow up old accounts sent to attorneys for collection.

Paid Invoices:

1. Check a receipted bill for each cash disbursement.
2. Note discounts not taken.
3. Post painting and decorating work to a worksheet, columnarizing so that duplicate charges may be easily distinguished.
4. See that prices are reasonable.

Insurance:

1. Examine policies at least once a year.
2. Prepare insurance schedule.
3. Reconcile insurance disbursements with items on schedule. See if rates appear reasonable.
4. Ascertain that proper refund or credit is received for any policies cancelled.
5. Review adequacy of fire and rental insurance. Note if managing agent and superintendent are bonded.

Payroll:

1. Check with previous period. Comment on changes.
2. Check employees' receipts.
3. Reconcile with social security and unemployment insurance tax returns.

Miscellaneous:

1. Reconcile managing agent's fee with cash receipts.
2. List unpaid bills at each accrual statement date.
3. Check leasing commissions with rules and rates of Real Estate Board.

4. Keep worksheet record of lessees' security deposits.
5. Determine rentable area for report purposes.
6. Scrutinize miscellaneous income; reconcile electricity profit with cost, charges to tenants, cost of building electricity, etc.
7. If electricity is submetered, verify vacancies during year with charges of submetering company.
8. Confirm tenants' arrears once a year.
9. Determine bad debts for annual report and discuss with agent or attorneys.

It is difficult to be forewarned against all the items which may arise during the course of the audit. However, the auditor should note the following:

(a) Commissions on lease renewals are usually one-half those paid on new leases. The auditor should familiarize himself with the allowable leasing commission rates.

(b) It is important to check the effective date of a renewal lease to see that it corresponds with the expiration date of the previous lease. This may disclose concessions. If possible the occupancy and lease dates should be compared.

(c) Check security deposits to the lease terms and see that deposits are applied when due; also, that deposits are handled in accordance with all pertinent provisions of the lease.

(d) Prepayments or security deposits are sometimes netted by the agent against amounts due from tenants. The totals of the respective items should be shown separately on a balance sheet, and security deposits should not be treated as prepaid rents.

(e) Gross collections for computation of agent's commission include collections of rent, electric charges and other income items. The agent is entitled to a commission on security deposits only when they are applied, not when collected. No managing fee is payable on expense or insurance refunds.

Special Problems In Auditing Records Kept On Accounting Machines

By Norman V. Bellenoit, C.P.A.

The rapid progress and development of accounting machines, and their general acceptance as being essential in office routine, have created for the professional accountant special situations which sometimes make him feel uncertain in dealing with records produced by them.

Actually, there should be no special problems in auditing records kept on accounting machines. Any unfamiliar situation in machine accounting may at first be looked upon as a problem, but upon analysis, we find that it is only uncertainty and fear of the unknown that creates that state of mind. Equipment that looks complicated impresses us, and we wrongly conclude that complicated mechanism must create problems. If knowledge and understanding are substituted for uncertainty and fear, nothing complex remains.

Accounting machines have been developed to perform certain functions quickly, easily, legibly and accurately.

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This paper was recently presented by Mr. Bellenoit at one of a series of discussion meetings arranged by the Education Committee of the Massachusetts Society of Certified Public Accountants, and appeared originally in the April, 1947, issue of their News Bulletin, with whose permission it is here reprinted.

In performing their functions, they generally use forms and methods with which we are all familiar. They take what we have in manual methods, and perform all or part of it mechanically, and the final results produced are practically the same except that one is written and the other is printed.

New developments create new conditions. If the accountant is familiar with office equipment, and if he promptly acquires knowledge and understanding of the purpose and application of new developments, he will eliminate the possibility of later encountering difficult situations.

Our discussion today will stress that point, and will include some suggestions and illustrations and some steps that should be taken in dealing with accounting machine records. It is not possible nor is it intended to cover the subject thoroughly. It is expected, however, that some of the more important facts will be uncovered and that some information will be provided to provoke thought and to stimulate further interest.

Because it is desirable to understand at least the basic, fundamental operating principles of the equipment used, the first approach to our subject will be to review the various types of office machines available today, and to discuss very briefly their purpose and place in accounting routine.

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(Ed. Note: This section has not been included.)

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The second approach to these problems will be to review some of the steps which should be included in that part of the audit program which covers accounting machine records.

In the examination of internal control practices, it is important to review the organization of the accounting machine department, and to determine how it fits in the line organization. The best internal control is obtained where the mechanical department operates in a staff capacity. It should render services to line departments where the controls are established and the verifications made. For example; a payroll department in the line organization should be charged with the full responsibility of the payroll. It should keep employee and rate records, contact department heads and employees, establish controls whenever possible, verify proofs, distribute checks or envelopes, etc. The mechanical department should perform for it, and should submit to it its proofs and finished products for verification and distribution. Better internal control is obtained by this method of operation. The more extensive a system of control, the less extensive will be the detailed checking necessary, and whereever mechanical devices are utilized, definite segregation of duties is an important part of internal control.

A study of the flow of work through a mechanical department, and of the processes and methods of proofs, should be made in detail at the time of the first engagement, and should be reviewed during every subsequent engagement as part of the check of internal control procedure. From such a study, the accountant can ascertain to his satisfaction whether or not the safeguards are adequate, and whether or not the results obtained are consistent from year to year for purposes of comparison. This study can be made without a thorough and complete knowledge of the equipment used. The auditor's experience in a wide variety of methods will serve him well in establishing the fact that the fundamental requirements of sound accounting procedure are met.

In manual methods, reliance is placed upon the ability and intelligence of the individual, and any individual tabulation is susceptible to individual and unrelated errors. The individual must read, transcribe, calculate, add and prove his work correctly. Machines perform some of these tasks for him quickly and accurately and they reduce the possibility of error. The human factors are utilized in mechanical accounting to a minimum degree and the results obtained are correspondingly more reliable.

The fact that mechanical records are more reliable than manual records should influence the auditor in determining the extent and scope of his examination. Generally speaking, supporting data and schedules produced mechanically should be verified in the same manner as those prepared manually, excepting that the amount of test checking may be reduced because of the methods used. The auditor should always be satisfied, however, that all records of any type of transaction are available for inspection. How much of the whole he selects for a complete and careful test checks depends upon the particular circumstances of the case.

Computing and recording mechanically is highly efficient, but it is not foolproof and should not be accepted as such. Difficulties arising from mechanical failures in office equipment are rare but the auditor should not overlook the possibilities of errors made by operators, and irregularities deliberately created by them.

Adding machine tapes are often submitted in support of various totals. These in most cases are correct, but the alteration of a printed tape total either upwards or downwards can very easily be accomplished by using the non-print key. This simple illustration is mentioned merely to bring out the point that there is no equipment on the market that is foolproof and that cannot be made to produce false totals or balances.

The third approach will be to discuss specific situations. There are many records produced on accounting machines which present no unusual prob-

lems in auditing. They are exactly similar in form and design to those that might have been written otherwise, and the auditor can conduct his examination with no interest in the medium of production, except insofar as it affects internal control and safeguards. The output of practically all bookkeeping and posting machines, and a large proportion of the output from punched cards fall within this group. The few remaining punched card records present to accountants some problems which are real, but in some cases some of the problems are without foundation. They may exist only because of a lack of knowledge or understanding of the methods used. If such a situation does exist and is corrected, those problems which are not inherently accounting machine problems will disappear.

There are some situations in punched card accounting which may not be entirely clear to the auditor and which may require some explanation.

The accountant sometimes finds it necessary to refer to punched cards directly in the course of his examination. This condition is usually the exception rather than the rule. In these isolated cases the auditor should have a clear understanding of the record itself and of its purpose. The card although used as a record is still a tool that can be used to actuate tabulating equipment and from it lists or tabulations in any sequence can be prepared in usable form. The auditor should request lists and tabulations so that reference to the cards is reduced to a minimum.

When the accountant requests lists or tabulations, or when he inquires about the capacity of a machine and its special devices, he is not exhibiting ignorance, or lack of understanding of punched cards. Actually, he is disclosing knowledge. It is impossible to tell from the cover of a machine what devices and capacities are installed within the machine. Manufacturers standardize on outside appearance of each model, but a blue print is necessary to find out what is under the covers. The accountant should not hesitate to ask for schedules which can be helpful to him in the conduct of his audit. He shows by such requests that he fully appreciates the speed and flexibility of punched card accounting, and also his ability to use its features to the best advantage. If, however, the volume of cards is great or if for any other reason the preparation of a complete printed schedule is impractical, the auditor may select at random a portion of the whole to be listed under his supervision for a detailed check.

In some rare instances, it is undesirable to disturb the cards, and reference to them directly is essential to complete an audit. Interpreted cards usually make up records of this nature, but lacking interpretations, the auditor should not experience too much difficulty in reading the punched holes in the field of the card which contains the pertinent data. Punched holes representing numerals are read in the same manner that depressed keys on an adding machine are read, except that the order of the digits is reversed. In punched cards, the zero hole is at the top of the card and the nine hole is at the bottom.

In planning his program, the accountant should anticipate his requirements for lists and tabulations as early as possible. There are some types of tabulating equipment that are designed to produce fixed and pre-determined reports and schedules, and alterations in form and content cannot be made by the client's staff, but they can be made by the manufacturer's representatives if sufficient time is allowed to do it.

There is a definite and growing trend in accounting routine towards the elimination of ledger accounts whenever possible, and towards the use in their place of slips, cards, or other documents in files to represent active open items. In effect, the posting media are filed in proper sequence instead of being transcribed on accounts. Punched cards are particularly well adapted to this type of record and they are used in

many installations in that manner for accounts and notes receivable.

The method most commonly used in accounts receivable is one where debit cards are punched and interpreted for each unit of payment, such as invoices, or total weekly or monthly charges. The cards are not usually created exclusively for accounts receivable. They may have previously served for billing, sales analysis and perhaps many other functions. They are kept in files and reflect the status of debtors' accounts at all times. In addition to the amount due, holes are punched to permit ageing and to identify the transaction and the debtor. Provision is made to punch the payment or other disposition of the item at a later date. As payments are made, cards covering the items paid are pulled from the file, are dated and are used to produce cash records and control totals. They are finally filed for historical reference or for special analyses.

From the auditor's viewpoint, that type of record lacks the convenient continuity to which he is accustomed. Nevertheless, it is in many cases an excellent application of work simplification, and the use of the idea will grow and it must be accepted. We have already accepted the almost universal discontinuance of ledgers for accounts payable, and auditors have been ingenious enough to conduct satisfactory examinations without them.

In the average balance sheet audit, the status and value of accounts at a given time is the major concern of the auditor. Historical reference is needed only to assist in the verification and appraisal of overdue accounts.

The punched card open item file actually simplifies the work of evaluating accounts receivable. From it, a complete trial balance can be listed and all the accounts can be aged. A separate list of overdue accounts can be prepared for the auditor's convenience thereby providing him with a condensed worksheet containing only the items requiring his special consideration. The record of payments is, or can be, legibly printed daily, and reference to it in following up the progress made in the collection of delinquent accounts is simple. Furthermore, an aged trial balance can be prepared for the auditor a week or two after the date of the examination to compare with the first one. This additional trial balance, after proper reconciliation with the control balances, is a valuable aid in establishing reserves for bad debts and in forming an opinion as to the worth of the accounts.

If the confirmation of accounts is contemplated, the punched cards can be used very effectively to print the forms. The entire operation can be performed under the auditor's supervision and control.

With facilities and schedules such as those described available to the auditor, his need for reference to the historical cards is limited, and while it is admittedly less convenient than a ledger account written in chronological sequence the advantages for both the client and the auditor far outweigh the disadvantages.

Punched cards are also frequently used in notes receivable records, particularly in those involving periodic instalment payments. In such cases, all scheduled future payments are represented by punched cards which are identical except for the date payment is due. The cards are available for trial balances, for analysis of delinquencies, for records of cash payments, and for notices, and for projection and review of future cash collections. The presence of punched cards facilitates the preparation of lists and does not hinder in any way the auditor's investigation.

There are several other methods of handling accounts and notes receivable records with punched cards. In any method, the auditor will find that it is almost always possible to work from lists prepared mechanically, and his reference to the cards themselves will comprise but a very small part of his work.

The use of punched cards in inventory records is a familiar function of tabulating equipment. There are many methods of controlling inventories with punched cards. The recording of quantities is common, the indication of quality, age and condition is less frequent, but can be incorporated in punched card methods. Pricing, computing, footing, and summarizing are also functions commonly performed by the use of punched cards.

The auditor in his examination of inventories should give consideration to all of the above stated factors, and in determining the scope of his verification, he can be guided by a study of the methods and by tests of their effectiveness. Many companies maintain comprehensive continuous punched card inventory records which are subject to periodic comparison with actual quantities on hand. Some utilize the cards at frequent intervals to prepare inventory lists which are used to check physical quantities. These lists are also used effectively by the buying and selling organizations, and are an important contribution to the successful operation of internal control measures.

A punched card inventory verification problem was presented to an accountant recently. A new corporation was formed to acquire and operate a large business. The problems involved in starting operations overnight were numerous, and the organization worked under pressure for several weeks before settling down to a normal routine with all details under control. Their complacent feelings were badly disturbed however, when it was discovered that the bylaws called for a fiscal year closing, instead of the usual calendar year closing. To further complicate matters, the accounting periods had been set up on a weekly basis, each period ending on Saturday, and the ending date of the fiscal period was on a week day. The problem was to close the books as of the end of the fiscal period, which dated back nearly three months, and to obtain a certified balance sheet as of that date, and prepare the necessary tax returns.

The accountant appraised the problems, and proceeded with an assurance that produced a marked stabilizing effect upon the organization. The major item in current assets was the inventory. His first step was to acquaint himself throughly with the inventory methods that were being used, and with the internal controls that had been established.

For each case of merchandise received a card was prepunched and filed by commodities in open tubs. As orders were received from stores, cards representing commodities ordered were pulled from the file, and used for billing, sales analyses, and inventory balance reports. The tubs, at all times, contained as many cards as there were cases on hand in the warehouses, and to test the accuracy and effectiveness of the method, certain items were systematically selected for verification. By removing all the cards of one commodity from the files, and by counting them mechanically, an up to the minute inventory balance was obtained and noted on work sheets. Assistants then made actual counts in the warehouse to verify the balances.

By following through the various processes to the final inventory balance reports and controls, the accountant established the fact that the records and methods were accurate and reliable, and the control values as at the required date were easily determined.

The subject of inventories is one which could be selected as the exclusive topic of one meeting. Because of the magnitude of the problems and the limited time available today, we will not discuss them any further in this part of the session, but we can discuss special problems if you have any during the question period.

The problem of continuity, or rather the lack of it in punched card accounting has often been mentioned as one likely to be confusing or inconvenient

for the auditor. Discussion of an actual case will be used to illustrate this point.

A summary list of the monthly general and subsidiary ledger charges and credits originating from journal and other vouchers is printed monthly. It contains the references to the source documents, the ledger accounts to be charged or credited, the amount of each individual item, the total net charge or credit to each account, and finally the grand net total of each ledger.

The final net totals for each account are posted to the general and subsidiary ledgers monthly, the lists being used as posting media. The ledgers therefore show the monthly totals only, and reference to the lists is necessary to obtain any detailed breakdown that is required for verification.

The lists are voluminous and are filed by months in several departments.

The objections raised to this type of record are usually based on the fact that lists for one account covering one year are filed in twelve locations, and reference is slow and inconvenient. This criticism is justified, but there are several suggestions that can be made to remedy the situation.

The lists can be made on individual statements for each account, so that all statements for one account can be filed together for one year; lists can also be prepared with hectograph carbon and the items posted to individual accounts by the use of the facsimile posting machine. Another method would be to file all lists together in one binder, thereby obtaining a record which would be similar to a voucher register. Aside from the inconvenience of reference, the auditor is not hindered in any way, as all reference data to the source documents are available to him.

The effectiveness of test checking is sometimes questioned in connection with records produced by punched cards. A punched card schedule, report or record, which is complete in every pertinent detail is as easily test checked as are those compiled by any other method. The capacity and flexibility of tabulating equipment make possible the preparation of complete reports in the sequence in which they can best be used, and the alteration of a report, in form, content, or sequence, to enable an auditor to make a more satisfactory test check can in practically all cases be accomplished. The system in use may have been designed from an efficient operating viewpoint, and a suggestion from the auditor to incorporate features convenient from his viewpoint undoubtedly would receive due consideration. Minor changes in procedure might be all that are necessary to produce records which will meet the requirements of both the auditor and the client's staff.

Throughout this discussion, three points have been emphasized: first, that the accountant should understand at least the fundamental operating principles of the equipment used to produce the records under review; second, that the accountant should include in his program a study of the methods used, a review of the organization of the mechanical department, and a thorough check of the internal control procedure; and third, that the accountant will find that in the majority of cases the records from accounting machines do not differ materially from those produced by manual methods, and that the application of accepted auditing methods applies with equal effectiveness to all types of records.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Combined Franchise Tax Returns —Control Test

Closely affiliated corporations may be required to file what amounts to a consolidated franchise tax return, although the law speaks of it as a combined return. If the affiliated group itself desires to file a combined return it must first obtain the permission of the State Tax Commission to do so. To file on a combined basis a corporation must own or control directly or indirectly substantially all of the capital stock of the affiliated corporations, or the affiliation may be through the ownership of the stock of the several corporations by the same interests. While the law itself does not define the term "substantially all", the regulations provide that ordinarily the beneficial ownership or control of 95% or more of the issued and outstanding voting stock meets the test (Article 560).

Combined Franchise Tax Returns— Factors Considered By Commission

The mere fact that the test of stock ownership or control is met does not mean that a group of affiliated corporations will be permitted to file a combined return. Other factors are considered by the State Tax Commission and these are enumerated in the regulations (Article 560) as follows:

1) Whether the corporations are engaged in the same or related lines of business.
2) Whether any of the corporations are in substance merely departments of a unitary business conducted by the entire group.
3) Whether the products of any of the corporations are sold to or used by any of the other corporations.
4) Whether any of the corporations perform services for, or lend money to, or otherwise finance the operations of any of the other corporations.
5) Whether there are other substantial inter-company transactions among the constituent corporations.

Combined Franchise Tax Return— Real Estate Corporations

The law itself (Sec 211 (4)) permits the State Tax Commission to require the filing of a combined return where there is the requisite control or ownership between a business corporation and a real estate corporation. There is the further requirement that a material part of the property of the real estate corporation is used or occupied by the business corporation in the conduct of its business. Whenever the State Tax Commission spots a situation of this kind it loses no time in requiring a combined report. As a consequence, the real estate corporation loses its favored classification as a corporation taxable under Article 9 and becomes taxable under Article 9A.

Combined Franchise Tax Return— Foreign Corporation

If the affiliated group includes a foreign corporation which is not doing business in New York, the latter need not generally be included in the combined report. However, if any agreement or arrangement exists between

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the foreign corporation and any of its New York affiliates which distorts the New York income of the affiliates, the Commission may require the inclusion of the foreign corporation in the combined return. This is permitted in order properly to reflect the tax liability of the New York taxpayers.

Combined Franchise Tax Return—Inter-Company Transactions

Where the tax is measured by entire net income the law requires the elimination of the inter-company dividends. Where the tax is measured by business and investment capital, the law requires the elimination of inter-corporate stock-holdings, inter-company notes and accounts receivable and payable. Combined subsidiary capital is likewise determined after elimination of inter-company stockholdings. However, in determining the percentage of receipts allocable to New York the regulations (Article 413(6)) provide for the elimination of inter-company business receipts.

Combined Franchise Tax Return—Minimum Tax

The law provides for a tax measured by combined entire net income or combined capital of all the corporations in the affiliated group. While each corporation is liable for the entire tax, the tax may be assessed against any one or more of the corporations in the group. In addition to the tax on combined net income or capital, each corporation included in a combined report (other than the corporation paying the consolidated tax) is required to pay a minimum tax of $25. This requirement is a hold-over from old Article 9A.

Combined Franchise Tax Return—Allocation

The allocation factors, real and tangible personal property, receipts, and payroll are the same for a combined return as for a separate return, except that the accounts of all the companies are combined (consolidated) with inter-company items including receipts eliminated. On a combined return the corporations do not have the option of allocating the combined entire net income by the business allocation percentage where the investment income is less than 25% of entire net income, nor may they allocate by the investment allocation percentage where investment income is more than 85% of entire net income. And where the basis of the tax is business capital, the affiliated group does not have the option of allocating total business and investment captial by the business allocation percentage where business income is 75% or more of entire net income.

Combined Franchise Tax Returns—Some Comments

In spite of all efforts to simplify the ordinary franchise tax reports, the preparation of the return can be a problem requiring expert handling. To the uninitiated a combined return can be really frightening because of the burden of detail required. (See Form 3 A C T)

The creation of a corporate entity is quite simple. It is therefore equally simple to set up corporate arrangements which may deflect income really earned in New York to corporations in foreign states. The combined return which the state can require prevents such tax avoidance. When a group of affiliated companies seeks permission to file on a combined basis it usually seeks a tax benefit. The usual situation will be one where not all members of a unitary business operate profitably. On a combined return the entire net income of one company will be offset by net losses of other companies.

In the usual situation the commission may not require the inclusion in a combined return of a foreign corporation which itself is not subject to tax in New York. This is now provided for in the law (Section 211(4)) although old Article 9A was silent on this point. However, the taxpayer may seek permission to do so and the Commission will grant

it if this will more equitably reflect New York income.

Under the present provisions of Article 9A a controlled real estate company and a business company may be required to file a combined return, provided the business company uses or occupies a material part of the property of the real estate company. Under old Article 9A the real estate company automatically lost its exemption from tax under that article. Under the present law if the Commission does not require a combined report the real estate company remains taxable under Section 182. There is no provision in the law giving the Commission authority to permit or require a combined return for a business corporation and any corporation taxable under Article 9 except a real estate company.

Establishing a business allocation on the basis of combined factors may give a group of corporations some tax advantage.

Even without the use of a combined return the Commission has the power under Section 211(5) to adjust the income of a taxpayer where profit diverting devices are being employed.

Under old Article 9A where the tax was measured by entire capital intercompany holdings were not eliminated. The present provisions have corrected this inequity and inter-company stockholdings as well as indebtedness are eliminated.

Once a group of companies file on a combined basis, they are probably committed to a continued use of this basis. It is up to the taxpayer to obtain permission to change its basis thereafter.

Status of a Foreign Corporation as a Business Corporation or a Real Estate Company

The assets of a foreign corporation consist of securities and cash. It has an office outside of New York. It purchases real estate in New York. Is it subject to tax as a business corporation or a real estate corporation?

Of course the mere ownership of real property within the state constitutes doing business in New York. As a domestic corporation the ownership of securities (excluding certain U. S. obligations) beyond 10% of the average gross assets would make the corporation a business corporation taxable under Article 9A on the first day of the following year. As a foreign corporation taxable in New York its only assets here being real estate, it should be taxed as a real estate company, although the State Tax Commission might hold it to be taxable as a business corporation based on the criteria applicable to a domestic company.

When Is Real Estate a Business?

Here is a fairly common income tax situation. A taxpayer owns some income producing real estate and for several years has paid ordinary income taxes on the net income or has received a deduction where the operations have resulted in a net loss. The taxpayer sells the real estate at a loss and having considered himself in the real estate business takes an ordinary deduction for the loss. The State Tax Commission takes a different view. The real estate has suddenly become an investment and hence the loss is construed as a capital loss subject to the less favorable capital gain and loss provisions. In one case which went to a formal conference, the taxpayer owned four parcels of property all of which were managed by an agent. The income from the real estate operations represented about forty per cent of taxpayer's total income. Taxpayer was a housewife and the rest of her income was derived from interest and dividends. The Commission clung tenaciously to its decision that the loss on the sale of the property was a capital loss.

The writer knows of a case where a taxpayer in a similar situation sold one parcel of real estate at a profit and reported the gain as a capital gain. The Tax Commission shifted its position and now held that the gain should be

taxed as ordinary income and, furthermore, that it should be subject to the unincorporated business tax as well.

Under the franchise tax law the mere holding of real estate constitutes doing business in New York. Under the income tax law because of the special treatment for capital gains and losses, income is classified as business income or investment income and the term business acquires a different emphasis. The difference in treatment by the Commission, based upon whether the transaction results in a gain or a loss, is a little more difficult to reconcile. The Tax Commission takes very seriously the frequent dictum of the Supreme Court that taxation is eminently a practical matter. That is not too comforting for the taxpayer.

Sale of Residential Property

There is an interesting contrast between the applicable Federal and New York State tax rules when residential property, devoted solely to personal use, is sold. Under both the Federal and State laws, such residential property is a capital asset and any gain or loss is therefore a capital gain or a capital loss. But there the similarity in treatment ends. The Federal government taxes the gain but does not recognize the loss. In computing the gain under the Federal rule, the cost or other basis is not reduced by depreciation for the period during which the property is held, inasmuch as such depreciation is neither allowed nor allowable.

Under the State tax law, however, not only is the gain taxed, but the loss is also recognized. And in arriving at such gain or loss, accumulated depreciation applicable to the period of ownership is deducted from the cost or other basis, despite the fact that the depreciation does not qualify as an allowable deduction during such period of ownership. It is therefore possible for the sale of a residence to result at the same time in a taxable gain under New York law and in an unrecognized loss for Federal Tax purposes.

Franchise Tax—Doing Business by Reason of the Holding of Real Property

Under Article 9 (Section 182) as well as Article 9A (Section 209.3) the holding of real property in New York is deemed to be doing business in New York and such a corporation is thus subject to franchise tax. A strict interpretation of these sections of the law may work a hardship on a taxpayer. Consider the case of a foreign corporation in the investment security business. As a result of a mortgage foreclosure proceeding it acquires real property in New York. The Commission held such a corporation taxable as a business corporation under Article 9A.

Some years ago an insurance company in Connecticut held a mortgage on some real property in New York. Through foreclosure it became the holder of the real property. The Commission at that time sought to tax the corporation as a real estate company under Article 9. In an opinion dated September 8, 1936, the Attorney General held that such an isolated transaction would not constitute doing business so as to make the corporation subject to franchise tax. When this opinion was quoted in the former case the Commission held that it applied only to real estate corporations taxable under Article 9 and that it had no application to business corporations taxable under 9A.

It is difficult to reconcile the ruling of the Commission in both cases. There certainly is not enough difference between Article 9 and Article 9A to warrant a different holding on the same set of facts. Both articles cover franchise taxes. The difference is primarily in the method of computing the tax. In the one case it is computed on gross assets and in the other on entire net income. Perhaps the law should be amended to exempt a corporation from franchise tax under either article where the real property held is acquired by foreclosure and the mortgagee is thus an involuntary holder of real property.

OFFICIAL DECISIONS *and* RELEASES

STATUS OF ACCOUNTING PERSONNEL UNDER FEDERAL WAGE AND HOUR LAW

The following letter may be helpful to practitioners in determining whether their accounting personnel are subject to provisions of the Federal Wage and Hour Law. It was written to Benjamin Greenberg, chairman of the Society's Committee on Administration of Accountants Practice by the Assistant to the Deputy Administrator of the Wage and Hour and Public Contracts Divisions of the U. S. Department of Labor.

"I have your letter of February 18, 1947, in which you inquire whether we have had occasion to issue any statement with regard to the applicability of the exemption for professional employees provided by part 541 of the regulations to accountants employed by public accounting firms. There has been no formal public statement regarding the applicability of the regulations to accountants. The following comments may however, be of value to you.

The exemption status of an employee under part 541 of the regulations depends, as you may know, on the particular work he does and whether he meets all the requirements of one of the applicable sections of the regulations. In the last analysis, the work performed by the employee is the determining factor rather than his title or his occupational grouping. Consequently, it is not possible to say that all accountants are exempt regardless of the type of work they do.

Generally, *certified public accountants* who are paid not less than $200 per month on a salary basis will, except in unusual cases, meet the requirements of the "professional" exemption. Such employees normally perform accounting work of the kind specified in the definition of the term "professional" contained in the regulations. Similarly, accountants who are not certified public accountants may also be exempt as "professional" employees provided that they actually perform professional accounting work, that is, work which requires the consistent exercise of discretion and judgment and which otherwise meets the tests of the definition of a professional employee. However there are many different types of accounting work in public accounting firms, at least some of which may not meet these tests. For example, such firms sometimes hire accountants who may be assigned routine work which they perform under close supervision. Such employees are not exempt.

I believe that if you apply the criteria in the regulations to accountants you will find little difficulty in determining which employees are exempt. The enclosed report of the presiding officer may also be of assistance to you. If, however, you should have any question regarding the status of a particular employee, I feel sure that your question can be resolved satisfactorily by consultation with a representative of the regional office of the Divisions which, for the New York area, is located at 341 9th Avenue, New York. That office, I am sure, will be glad to assist you in determining whether a particular employee meets the requirements for exemption."

BOOK REVIEWS

Bank Frauds, Their Detection and Prevention,

By Lester A. Pratt. THE RONALD PRESS COMPANY, New York, 1947. vi + 248 pages, $4.00.

This book is primarily written for those whose duties and responsibilities include the prevention or detection of bank frauds. Its obvious purpose is to draw attention to the seriousness of the losses arising out of such frauds and to point out methods which would aid in minimizing them. The author's purpose is well served by this compact and well written treatise.

The text consists of 220 pages of real information. The first chapter is devoted to a startling revelation of the volume which bank defalcations have attained. Perhaps this will not surprise those familiar with bank affairs but it surely will shock the average reader. A substantial part of the book is employed in the analysis and description of bank operations and the accounting and office methods and procedures used. The deficiencies in these methods and procedures especially those used in the smaller banks or in banks that may be dominated by one person are elaborately detailed. The author dwells on the opportunities these failures have offered to weak or dishonest employees.

An interesting tabulation compiled from reports of the Comptroller of Currency for the period 1915 to 1931 is given on page 69. It shows the various positions held by bank employees who were convicted of criminal acts in National Banks. The tabulation is arranged in comparative form to show convictions for defalcations originating in small banks and large ones. The statement shows that 821 of the 1481 convictions were for criminal acts which were perpetrated in smaller banks. Of these 580 were committed by management employees and 241 by subordinate employees. With the larger banks the reverse is true in that of the 660 applicable cases 112 represented misdeeds of management employees and 548 those of other employees.

The underlying procedures involved in the perpetration of fraud are developed for the reader and actual cases are cited from authentic sources. These cases are related to specific departments in the bank. The functions and purposes of these departments are explained so that even a layman may find interest in the recital.

The author next approaches the subject of prevention. The importance of internal control, the urgent need for arranging duties so that vulnerable procedures will be performed by or come under the supervision of more than one person and the need of rotation of personnel on different phases of the work are stressed. He urges the frequent detachment of employees from customary duties and stresses the requirement that all take vacations. These steps are pointed to as important safeguards against systematic or continuous fraud.

Methods of fraud detection are described and comprehensive programs for guidance in the examination of various bank activities are given throughout the book.

The author dwells on the importance of regular examinations by directors or trustees and recommends the engagement of public accountants to assist or to conduct such examinations. This book should be of value to any public accountant but particularly to those who on occasion find themselves involved in the examination of financial institutions. Its lessons will not come amiss to anyone engaged in auditing work. Bank examiners, internal bank

auditors, officers and directors will find much to assist them in their responsibilites.

Many cases cited are undoubtedly of a type familiar to those associated with banks but the variety of the opportunities for frauds mentioned by the author may surprise some of these. It certainly will impress the reader with the importance of the author's subject.

The book is suggested as a fine addition to your technical library. Its appendix and index make it a handy reference book to the examiner.

CHARLES A. HOYLER

Hurdman and Cranstoun
New York, N. Y.

Departmental Cooperation in Cost Reduction,

Financial Management Series No. 85. AMERICAN MANAGEMENT ASSOCIATION, New York, 1946. 26 pages \$.50 to non-members.

"Departmental Cooperation in Cost Reduction" begins with an excellent introduction by Mr. Wyman P. Fiske, Secretary of the National Association of Cost Accountants, in which he outlines the relationship of accountants to cost reduction. Following this, there are separate sections for insurance, sales, customer service, production, and office (management).

One of the purposes of the pamphlet is to present the various viewpoints of each of the internal departments of a business with respect to costs. Accordingly, each section of the pamphlet has been prepared by a recognized leader in his field of specialization. The result is to provide twenty-six pages which contain pertinent comments and suggestions which range, in importance, from minor day-to-day measures to drastic changes in operating policies.

The pamphlet affords the accounting practitioner the opportunity to review and, perhaps, broaden his own ideas on cost reduction. In this, it should assist him in developing valuable guide lines for cost discussions with business executives. On the other hand, the pamphlet, if used as supplemental reading, will be invaluable to a cost accounting student in that it emphasizes the practical ways in which cost reductions are actually achieved.

C. W. BASTABLE, JR.

Columbia University
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The 103rd New York Certified Public Accountant Examination

— May 14, 15 and 16, 1947 —

THEORY OF ACCOUNTS

Thursday, May 15, 1947 — 9 a. m. to 12.30 p. m., only

Group I—Answer all questions in this group.

1 *a* What kind of transactions would necessitate the inclusion of an item of Unearned Income on the balance sheet?

b Should an Unearned Income account be included in the proprietary section of the balance sheet? If not, where should it be included?

c What disposition should be made of the balance of an Unearned Income account on the company's books? [10]

2 When should liabilities for *each* of the following be recorded on the books of an ordinary business corporation: (*a*) dividends, (*b*) purchase commitments, (*c*) acquisition of goods by purchase on credit, (*d*) officers' salaries, (*e*) special bonus of employees? [10]

3 *a* Explain briefly the meaning of the terms *prepaid expenses* and *deferred charges.*

b What is the preferable way of treating these items on the balance sheet? [10]

4 A Corporation was considering, in 1946, the issuance of bonds as of January 1, 1947, as follows:

Plan 1: $1,000,000 par value 5%, 1st mortgage, 20-year bonds, due December 31, 1966, at 94

or

Plan 2: $1,000,000 par value 5%, 1st mortgage, 20-year bonds, due December 31, 1966, with provision for payment of a 6% premium upon maturity

Give *two* separate sets of journal entries with appropriate explanations showing the accounting treatment which the foregoing bond issues would necessitate, respectively, (*a*) at time of issue, (*b*) monthly thereafter, (*c*) upon payment at date of maturity.

Cost of issue such as printing, lawyers' fees, etc. may be ignored for the purpose of answering this question. Discount and premium are to be allocated to accounting periods on a straight-line basis. [10]

5 State *briefly* the preferable position on the balance sheet in which *each* of the following should be shown; if any of the items should not be shown on the balance sheet, indicate accordingly: [10]

a Capital surplus

b Merchandise out on consignment

c Pension fund on deposit with a trustee (under a trust revocable at depositor's option)

d Reserve for depreciation of plant and equipment

e Materials in transit—purchased F. O. B. shipping point

f Self-insurance reserve

g Reserve for doubtful accounts receivable

h Merchandise held on consignment

i Intangible assets

j Contingent liabilities

Group II—Answer five questions from this group.

6 *a* What item on the balance sheet may be subjected to the "gross profit test"?

b Using assumed amounts, demonstrate by a summary statement how the test is applied. [10]

7 The bookkeeper of a large hardware company has made a practice of setting up raw materials and the corresponding accounts payable at the gross purchase price including trade and cash discounts.

a Mention *four* important respects in which such a procedure might distort the company's balance sheets.

b State at least *one* way in which the operating statements based thereon would be distorted thereby. [10]

8 Compare the last-in, first-out method of computing inventories with the first-in, first-out method. [10]

9 *a* Define the term *working capital.*

b State briefly what is meant by the term *working capital ratio,* how such ratio is calculated and how it is ordinarily stated. [10]

10 *a* Is there a duplication of charges to current year's costs or expenses in cases where a sinking fund reserve is created for the retirement of bonds, as well as a depreciation reserve with respect to the capital assets by which such bonds are secured?

b Discuss briefly the point raised by this question. [10]

11 *a* State the relationship among business organizations that makes the preparation of consolidated financial statements advisable.

b State briefly the purpose of preparing consolidated financial statements. [10]

12 *a* Name *four* important items relating to the accounts of a partnership as to which information should be obtainable by reference to the partnership agreement.

b In the absence of a specific direction in the partnership agreement, how should withdrawals of a partner during a fiscal year, which exceeded that partner's share of profits for the year, be treated? [10]

COMMERCIAL LAW

Friday, May 16, 1947 — 9 a. m. to 12.30 p. m., only

Group I—Answer all questions in this group.

1 *a* What is the effect of fraud upon a contract?

b What choice of remedies has the defrauded party?

c Where a party breaks his contract, what rights has the other party?

d What is an accord and satisfaction?

e A lease under seal contained a clause giving the lessee the option to purchase the leased premises during the term of the lease for the sum of $1,000. The lessee during the term tendered the lessor the $1,000 and demanded a deed. The lessor refused the tender and the deed on the ground that the option was unilateral and without consideration. Was he justified in his refusal? Explain. [10]

2 *a* Name the essentials of a negotiable bill or note.

b Is a note negotiable which gives the holder an option between payment in money and some other thing?

c What implied warranties are made by an indorser?

d When does title to a note or bill pass by operation of law? Name *three* instances.

e A made a note payable to B with interest. The note was undated. From what time does interest run?

f A gave his negotiable promissory note to B for $1,000. B fraudulently altered the note to read $10,000 and transferred it to C, an innocent holder, for value in due course. Can C maintain an action against A on the note and, if so, what sum will he recover? [10]

3 *a* (1) What is a *de facto* corporation?
(2) What is its status, (*a*) in general, (*b*) as to the state, (*c*) as to others?

b The officers of a manufacturing corporation, by authority of the directors, indorsed, in the corporate name, a note for the accommodation of an allied corporation. The note was discounted by a bank on the faith of the indorsement and with knowledge that it was indorsed for accommodation.
(1) May the corporation do this? Why?
(2) Was the bank a holder in due course? Why?
(3) May the bank recover upon the indorsement? Why?

c A corporation was engaged in mining. Another corporation was engaged in manufacturing. The two entered into an agreement of partnership.
(1) Was this agreement within the powers of the companies?
(2) Can a corporation enter into a partnership with another corporation in the same line of business? Why? [10]

4 *a* What is a factor?

b What is a factor under a *del credere* commission?

c Is a *del credere* agent liable to his principal as guarantor or as principal debtor?

d What is the scope of authority and powers of an agent employed to manage a particular business?

e What are the exceptions to the general rule that an agent can not delegate his authority?

f Green Company gave credit to Allen, who was really the agent of Burt. The agency was unknown at the time but it was ascertained after Burt failed. Could Allen be held?

g Title to land was conveyed by deed to "John Jones, President of the Jones Company." The John Jones Company was a corporation. In whom is the title vested? [10]

5 *a* What is meant by the net operating loss carry-over and the net operating loss carry-back?

b (1) To what years may a net operating loss carry-back and the net operating loss carry-over be applied?
(2) In what order are they applied?
(3) Is there a choice of order?

c In 1942 and 1943 the taxpayer had net incomes (after adjustments) of $3,000 and $10,000 respectively. In 1944 a net operating loss of $5,000 was sustained, and in 1945 a net operating loss of $14,000 was sustained. Illustrate the operation of the net operating loss carry-back and carry-over.

d What is meant by constructive receipt?

e Jones has a deposit of $5,000 in the A Savings Bank, which credits interest on its deposits at the end of each year. Jones was ill during the latter part of 1945 but in February 1946 he went to the bank, which entered interest of $100 for 1945 on his bankbook. For what year should Jones report this income? [10]

Group II—Answer five questions from this group.

6 *a* (1) In bankruptcy, what constitutes a proof of claim?
(2) Where must such claim be filed?
(3) When must such claim be filed?
(4) For what purpose must such claim be filed?
(5) What happens to proof of claims not filed within the statutory period of limitations?
(6) What is that period?

b In bankruptcy, have any debts priority in payment? If so, what kinds? How do they rank and to what extent?

c A receiver in bankruptcy employs a public accountant to examine and report on the accounts of the bankrupt.
(1) May the receiver do this?

(2) What is required?

(3) How is the compensation for the accountant's services determined? [10]

7 *a* Can a partnership hold real estate in its firm name?

b What is meant by the rule that partnership realty is considered as personalty, and when does it apply?

c What is a sufficient notice of a dissolution by act of the partners?

d Is a partner entitled to compensation for services rendered the firm?

e Equal partners, Allen and Burt, have assets consisting of real estate of the value of $20,000, personal property of the value of $10,000 and liabilities of $8,000. Allen dies with personal liabilities of $5,000 and no assets other than his interest in the partnership property. What is the effect of Allen's death upon the partnership? How should the surplus of the partnership property be applied and distributed? [10]

8 *a* Name and describe the general provisions of the statute of frauds applied to sales.

b In sales of goods specially manufactured, how does the statute of frauds apply?

c What are the essentials of a written memorandum in order to satisfy the statute of frauds?

d Must the memorandum be in a special form or a single writing? Who must sign?

e A seller of goods drew on the buyer for the price of goods and transferred the bill of acceptance and the bill of lading together to the buyer. The bill of lading was to the order of the consignee and was indorsed in blank. The buyer did not honor the bill of exchange but indorsed the bill of lading to one who purchased the property in good faith for value and without notice that the bill of exchange was not honored. What are the purchaser's rights as to the title to the goods? [10]

9 *a* (1) Is a contract of insurance assignable? Why?

(2) What is the nature of an insurance contract between insurer and the insured in relation to the property covered? Does such insurance accompany the covered property on transfer or sale?

b On the sale of property, can the seller assign to the buyer his interest in the fire insurance policy on the property? Explain.

c What rights have creditors of the insured under fire insurance policies payable to the insured (1) before fire loss, (2) after fire loss?

d What rights does a trustee in bankruptcy take in the bankrupt's life insurance policies (1) in policies payable to his estate, (2) in policies payable to third party beneficiaries? [10]

10 *a* What is the essential difference between a bailment and a sale?

b Give at least *four* of the most important principles generally common to bailments.

c Into what *three* general classes are bailments divided?

d Carr deposited two rings with Burt for safekeeping. Burt sold them for a valuable consideration to Daniels, who did not know of the bailment. In a suit by Carr against Daniels, can Daniels set up his title through Burt?

e Allen rented an automobile to Burt for a month. During that month the automobile was destroyed in a collision with a truck owned by Carr, through the joint negligence of the servants of Burt and Carr. Allen sued Carr for damages. Could he recover? [10]

11 *a* Name the usual parts of a deed to real property.

b What are the granting and habendum clauses of a deed?

c When does a deed become effective?

d (1) Name the *five* usual covenants in a deed.

(2) Which covenants are personal?

(3) Which run with the land?

e What are the essential differences between a warranty deed and a quitclaim deed?

f What are the usual covenants in a warranty deed? [10]

12 *a* What does the word "certify" indicate as applied to bank checks?

b The cashier of a national bank certified a depositor's check for $1,000. The depositor's account at the time showed a credit balance of $500, as the cashier knew.

(1) Was the certification lawful?
(2) What was the cashier's liability?
(3) Is the check a valid obligation of the bank?

c A director of a national bank procured for a firm a loan of $100,000 from the bank in which he was a director. The firm agreed to pay the director a commission of $1,000 for this service, which he received from the firm in the form of a promissory note for $1,000. The note was not paid at maturity. He sues on the note.
(1) Can the director recover on the note?
(2) What was the status of the agreement between the firm and the director?
(3) What was the nature of the director's act? [10]

THEORY OF AUDITING

Friday, May 16, 1947 — 1.30 to 5 p. m., only

Answer all questions.

1 Prepare a detailed audit program showing step by step the audit procedures you would follow in making the examination in which one of the most important phases involves marketable securities of substantial value, including stocks, bonds and mortgages. For the purpose of this question, give in detail the section of your program covering your audit of these investments. [15]

2 Your client, the City Store, has 25,000 active accounts receivable. As of November 30, 1946, a month preceding the close of the fiscal period, trial balance tapes of the accounts receivable were prepared as a part of your interim audit work. These trial balance tapes were checked to the individual accounts receivable, were footed, and the total agreed with the general ledger controlling account.

Confirmation of receivables at November 30, 1946, was on the following basis:

Accounts in excess of $200 (1000 accounts aggregating 60% of the dollar amount of the receivables) were circularized with request for direct reply; negative confirmations were sent to the other customers. Differences reported had been satisfactorily reconciled.

Ignoring the question of uncollectible and past-due accounts, what additional audit procedures would you recommend in connection with the accounts receivable at the end of the calendar year? [15]

3 Prepare a questionnaire for the evaluation of Internal Control covering cash receipts, for use in your initial annual audit of a large manufacturing company whose sales are made directly to retailers. [15]

4 State your views as to the propriety of accepting a contingent fee in a professional accounting engagement. State reasons, noting exceptions, if any. [6]

5 During the course of your audit of the Burney Corporation, which was organized in June, 1946, you came across the following account in the general ledger at the date of the audit, December 31, 1946:

FIXED PROPERTIES

Date 1946	*Item*	*Debits*
June 8	Organization fees paid to the state	$ 1,500
June 16	Bond discount	2,400
June 16	Land site and old existing building	240,000
June 30	Corporate organization costs	3,000
July 2	Title clearance fees	2,800
August 28	Cost of razing old existing building	4,200
September 1	Salaries of Burney Corporation executives	9,700
December 12	Stock bonus to corporate promoters; par value per share, $10; 2,000 shares	20,000
December 15	Bond interest, six months	1,500
December 15	County real estate tax	2,200
December 15	Cost of the new building completed	555,000

Moreover, during the course of this audit, the analysis of the foregoing account and of other accounts disclosed the following information:

a The building acquired June 16, 1946, was valued at $40,000.

b The company paid $4,200 for the demolition of the old existing building, then sold the scrap for $200 and credited the proceeds to Miscellaneous Income.

c The company excutives did not participate in the construction of the new building.

d Bonds of a par value of $100,000, life 10 years, were sold to an underwriting syndicate at 97.6.

e The county real estate tax was for the six months ended December 31, 1946, and was assessed by the county on the land.

Prepare adjusting entries to correct the Fixed Properties account. Each journal entry should include an explanation. [15]

6 [12]

a Design an inventory tag and stub for use by a client conducting a moderate-sized wholesale plumbing material and supply business.

b Write a memorandum of instructions such as might be necessary to instruct the client's employees in the use of the tag and stub.

7 As of January 1, 1947, the Everlast Leather Company leased several acres of land, on which they immediately built a shoe manufacturing plant of steel and brick construction. This building has an estimated life of 50 years. On March 31, 1947, they sublet a two-acre section to Keepwarm Furnace Manufacturing Company, which has constructed a wooden building having an estimated life of 25 years. Everlast's lease is for 40 years and the sublease to Keepwarm is for 30 years.

Under these circumstances, what steps should an auditor take? Your answer should be in the form of an audit program. [10]

8 How would you satisfy yourself as to the correctness of the relative expenditures in a case were you are auditing the books of the Town of Oakville and those of the Oakville Sports Center? The Sports Center is being maintained partly by the town and partly by voluntary gifts of residents. Your answer should be in the form of brief programs. [12]

PRACTICAL ACCOUNTING — PART I

Wednesday, May 14, 1947 — 1.30 to 6 p. m., only

Solve both problems. The figures in brackets indicate the number of credits allowed.

1 Following are trial balances of A Company and its subsidiary, B Company, at December 31, 1945. From them and the other information given, prepare a columnar consolidating work sheet showing in separate columns a consolidated balance sheet and a consolidated income statement at December 31, 1945. [30]

Debits	*A Company*	*B Company*
Cash	$ 545,200	$ 267,300
Receivables, customers	187,000	375,400
War bonds	1,575,300	556,000
Inventories	398,200	146,800
Investment, B Company		
Bonds	198,000	....
Capital stock	300,000	....
Advances	226,600	....
Investment, A Company bonds (at par)	....	30,000
Fixed assets	2,311,000	714,700
Unamortized bond discount	....	2,700
Goodwill	....	90,000
Cost of sales	3,280,500	1,676,100
Selling and administrative expense	333,000	261,000
Depreciation expense	184,000	42,600
Interest expense	24,000	19,700
Bond discount amortized	....	300
Amortization of premium on B Company bonds owned	2,000	....
Provision for income taxes	600,000	420,000
Dividends paid	100,000	20,000
Total debits	$10,264,800	$4,622,600

Credits		
Accounts payable	$ 79,200	$ 69,500
Accrued income taxes	624,800	431,400
Other accrued expense	10,000	4,000
Advances from A	....	226,600
Reserve for bad debts	2,500	3,200
Reserve for depreciation	1,420,600	302,300
Reserve for postwar adjustments	1,000,000	445,000
First-mortgage 3% bonds	800,000	....
First-mortgage 4% bonds	....	200,000
Capital stock	1,000,000	200,000
Paid-in surplus	50,200	....
Earned surplus, December 31, 1944	424,700	90,200
Sales	4,797,300	2,644,500
Interest — war bonds	20,400	5,000
— intercompany bonds	7,200	900
— advances to B Company	11,700	....
Dividend received	16,200	....
Net profit	....	....
Total credits	$10,264,800	$4,622,600

A Company, on January 1, 1937, purchased from security holders its 81% interest in the capital stock of B Company and 90% interest in B Company bonds, the total consideration being $516,000 of which $216,000 was allocated to the bonds. The purpose of the purchase was to obtain additional manufacturing facilities and B Company's established markets for products similar to A Company's regular line. The earned surplus of B Company as shown by its books on December 31, 1936, was $150,000. The 25-year, first-mortgage 4% bonds had been originally marketed on December 31, 1929, to net 96¼.

For several years a part of the output of B Company has been an intermediate product sold to A Company at a uniform markup of 20% (on sales). Sales of this character recorded on B Company's books were $258,000 for 1945, of which $64,500 remained in A Company's inventory at the end of the year; the corresponding amount in A Company's inventory at the beginning of the year was $82,000.

A Company has made advances to B Company on which the latter pays interest semi-annually at the rate of 6% per annum. During 1945 (on July 1) an additional $50,000 was advanced.

A Company constructed a building at a cost of $100,000, which on January 1, 1940, was turned over to B Company for its use, at a price of $120,000. Depreciation of 3% has been accrued thereon since that date.

2 The stockholders of the Farm Equipment Company, vendors of horsedrawn machinery, resolved at their meeting of June 13, 1946, to liquidate as of August 31, 1946. The May 31, 1946, financial statement on which the stockholders predicated their decision to liquidate follows:

BALANCE SHEET
As at May 31, 1946

Assets		
Cash		$ 36,750
Accounts receivable		33,500
Inventory of merchandise		120,250
Total current assets		$190,500
Furniture, fixtures, trucks, etc., less reserve		20,500
Land and building, less reserve		30,000
		$241,000
Liabilities		
Accounts payable, including taxes		$ 15,600
Interest accrued on mortgage		250
Accrued payroll		450
Total current liabilities		$ 16,300
6% Mortgage due January 1, 1948		10,000
Capital stock, 4200 shares, par value $50		210,000
Surplus — Balance at Jan. 1, 1946	$24,050	
Less loss for 5 mos. to May 31, 1946	19,350	
Balance		4,700
		$241,000

According to the stockholders' resolution of June 13, the liquidation is to be effected by the directors (who, being principal stockholders, serve without compensation) as follows:

"The $15,000 cash bid of a local real estate operator for the equity in the land and building is to be accepted immediately, the purchaser to assume the outstanding mortgage of $10,000 and to pay all expenses of title search, closing, etc. Title is to pass as of June 30, 1946, and Farm Equipment Company is to pay mortgage interest accrued to that date. Insurance and taxes prepaid prior to June 30, 1946, are to be absorbed by the vendor.

"All merchandise on hand is to be offered for sale at 80% of regular sales prices; such special sale to be conducted from June 17 to June 27 (both dates inclusive). These sales are to be on a strictly cash basis and to be final—no returns permitted.

"An auction is to be conducted on June 29 on the company's premises and is to include all merchandise not disposed of during the previous 10-day sale. All furniture, fixtures, trucks and other equipment are also to be auctioned at this time. All sales made at such auction are to be strictly cash and final.

"Any merchandise still remaining unsold after the auction is to be advertised daily in newspapers of neighboring communities and disposed of at best prices obtainable.

"All employees, except the manager-bookkeeper, are to be given immediate notice of their release, at the close of business on June 29, and to be paid up to July 31. The manager-bookkeeper is to be given immediate notice of his release effective August 31, 1946, on which date he will be paid his salary for the four months ending December 31.

"A liquidating dividend (final) is to be paid on September 2, 1946, as of August 31, 1946, to all stockholders of record as at August 31, 1946."

Sales of merchandise to regular customers on credit for the period from June 1 to 16 inclusive amounted to $9,500 and were merged with the liquidation sales. All merchandise unsold after the auction was finally disposed of in August.

Depreciation subsequent to May 31, 1946, may be ignored.

Following is a summary of the cash transactions for the three months ended August 31, 1946:

	Cash Transactions	*Debit*	*Credit*
June	Cash sales — regular	$ 5,850	
	Accounts receivable collections	23,500	
	Cash sales (special 20% discount)	47,350	
	Cash received from auction sales		
	Merchandise	31,500	
	Furniture, fixtures and trucks	8,250	
	Auctioneer's commission and expenses		$ 2,850
	Interest on mortgage paid to May 31		300
	Proceeds from sale of land and building	15,000	
	Officers and office salaries, including separation payments and $450 accrued payroll		5,550
	Accounts payable		15,600
July	Accounts receivable collections	1,250	
	Postauction sales		
	Merchandise	3,500	
	Furniture, fixtures and trucks	2,300	
	Salary of manager-bookkeeper for July		400
August	Accounts receivable collections (final)	3,700	
	Collection agency fees		375
	Salary of manager-bookkeeper (including separation payment)		2,000
	Legal fees and expenses re liquidation		675
		$142,200	$27,750

You are required on the basis of the foregoing to prepare: [20]

a Necessary adjusting entries

b A columnar work sheet showing the postings of cash transactions, the adjustments and the cash available for final distribution

c A statement of loss on realization and expenses of liquidation

d A statement showing the amount of cash to be distributed as a liquidating dividend to *each* of the following stockholders:

A	1,600	shares
B	1,200	shares
C	900	shares
D	360	shares
E	140	shares
Total	4,200	shares

PRACTICAL ACCOUNTING — PART II

Thursday, May 15, 1947 — 1.30 to 6 p. m., only

Solve problem 3 and either problem 4 or problem 5. Figures in brackets indicate the number of credits allowed.

3 From the following information, prepare a balance sheet as at December 31, 1944, in accordance with the authorization of the Board of Directors referred to below. Your adjustments should be clearly keyed by letters or numbers on your Working Trial Balance. [30]

The Construction Corporation is engaged in a variety of construction work under contracts, the collections on which are made on the basis of engineering and architects' estimates as to stage of completion. Customers usually retain a percentage of the amount of each estimate pending completion of the contract.

Gross profit on contracts has been shown in the books and financial statements in the year of completion. Since experience has shown the loss on contracts to be negligible, the Board of Directors authorized the restatement of the accounts on the basis of accruing income in proportion to completion of contracts during 1944.

A trial balance of the general ledger of Construction Corporation at December 31, 1944, is as follows:

	Debit	*Credit*
Cash	$ 210,100	
Imprest work funds	10,000	
Earned receivables—billings based on engineers' and architects' certificates	315,000	
Retained percentages receivable	110,000	
Postwar excess profits tax refund credit	32,000	
Advance purchases	220,000	
Prepaid insurance	31,000	
Investment in subsidiary company (Jones Sand Co., Inc.)	100,000	
Advances to subsidiary company (Jones Sand Co., Inc.)	48,000	
Land	60,000	
Buildings	240,000	
Machinery and equipment	1,375,000	
Reserve for depreciation—buildings, machinery and equipment		$ 700,000
Notes payable to banks		40,000
Accounts payable—trade		290,000
Estimated federal income and excess profits taxes payable		150,000
Accrued taxes—other than federal taxes on income		25,000
Accrued expenses		22,500
Purchase money mortgages payable June 30, 1946		200,000
Common capital stock		125,000
Capital surplus		275,000
Earned surplus, January 1, 1944		318,600
Contract sales—billed revenues		3,370,000
Cost of contracts in progress	612,000	
Cost of contracts completed	1,828,000	
Administrative and general expenses	175,000	
Provision for federal income taxes—1944	150,000	
	$5,516,100	$5,516,100

Relevant data:

(1) Summary of construction in progress:

		January 1, 1944 Balance		*1944*	
Contracts	*Total Contract Price*	*% of Completion*	*Cost*	*% of Completion*	*Cost*
A	$1,200,000	85	$814,000	15	$119,000
B	1,300,000	40	305,000	14	107,000
C	900,000		....	35	200,000
D	500,000		....	100	375,000
E	450,000		....	100	340,000
F	240,000		....	100	180,000

(2) The balance of $3,370,000 in "Contract sales-billed revenues" account represents (*a*) the total of completed contracts billed in 1944 plus (*b*) incompleted contracts billed, as follows:

Contract B	$675,000
Contract C	305,000
	$980,000

(3) In its federal income tax returns, the company reports contract gross profit on the basis of completed contracts. An estimated federal income tax liability of $150,000 had been provided for in the accounts during 1944. The effective tax rate for 1943, 1944 and 1945 may be considered as being 40% of net income (disregard interest on any prior years' income taxes and the applicability of any other sections or provisions of the Internal Revenue Code).

(4) Construction Corporation is using equipment of its wholly owned subsidiary, the Jones Sand Company, Inc., on Contract C, and in lieu of rent is allowing that company 50% of the gross profit on the contract, after deducting such rental charge. Such allowance is not shown in the accounts.

(5) The corporation made advance payments for equipment; these appear as charges in the advance purchases account as follows:

Cash advanced for machines not received	$ 40,000
Cash advanced for machines received in December 1944 and in yard	70,000
Credits to trade accounts payable for machines completed, billed and held by vendors — not paid for	110,000
	$220,000

Answer either question 4 or question 5.

4 The Board of Aldermen of the city of Fulton determine to pave First Street at an estimated cost of $100,000 and take necessary legislative action to initiate the project. The charter of the city requires that the cost of such projects be shared 60% by the city at large and 40% by the district benefited. Bids are obtained and the contract for the work is awarded the A B C Construction Company for $95,000.

The accounts of the city are maintained on a full accrual basis with provision for encumbering appropriations and with assessment and other characteristic groups of accounts separated. The city has a Revolving Fund of $125,000 which is used to finance uncollected assessments receivable and projects in process pending completion and assessment. This fund at present is invested in assessments receivable and other projects in process aggregating $75,000, and consequently $50,000 must be borrowed temporarily on certificates of indebtedness to finance the First Street project Ten per cent of the front footage of property in the district benefited is city-owned, half of that amount having been acquired through foreclosure of tax liens and half representing the front footage of public buildings and facilities. Street improvement bonds, which will be general obligations of the city, will be sold to finance the city's share of the cost of the improvement. In answering part *a* of this problem, you may disregard any question of premium or interest on the temporary certificates of indebtedness and on the bonds; also ignore the fact that property improvement assessments are usually payable in instalments.

Answer both *a* and *b*: [20]

a Prepare a series of entries in journal entry form, with complete explanations accompanying each, recording the various actions and financial transactions relating to this undertaking as they might appear in the Assessment Fund accounts of the city.

The Assessment Roll submitted to the Board of Aldermen for confirmation provided for the payment of the assessment against respective properties in five equal instalments and was confirmed by the Board, as submitted, without change.

b You are required to prepare a draft of an Assessment Roll, making thereon *two* specimen entries for *two* separate property owners with respect to the first and second instalments.

5 Submit pertinent working papers, a reconciliation of all reciprocal accounts of the three companies and an accounting of the differences between the original and corrected net income figures in summary form for use in preparing the income tax returns of X and Y. [20]

X is a processor of steel parts for machines, trading as the X Machine Company. Y assembles machine parts and trades as the Y Assembly Company.

On January 1, 1945, X and Y decided to form a partnership, to be known as the General Manufacturing Company. It was contemplated that each partner would continue his own business, dealing both with the partnership and with outsiders. The profit and loss ratio was X 40% and Y 60%.

Statements of profit and loss follow. No audit was made of the accounts before preparation of the following statements:

	X Machine Co.	*Y Assembly Co.*	*General Mfg. Co.*
Sales	$265,000	$540,000	$870,000
Cost of sales	154,000	372,000	525,000
Gross profit	$111,000	$168,000	$345,000
Expenses	78,000	93,000	210,000
Net profit from operations	$ 33,000	$ 75,000	$135,000
Gain on sale of business property	3,500	....	3,000
Loan by Y, deemed worthless on account of adjudication in bankruptcy	....	2,000	....
	$ 36,500	$ 73,000	$138,000

An audit of the accounts and records of the three companies at December 31, 1945, disclosed the following:

Included in Cost of Sales of General Manufacturing Company were purchases from X Machine Company of $135,000. Sales to General Manufacturing Company on the books of X Machine Company were $145,000. Analysis of the discrepancy discloses that X Machine Company had billed General Manufacturing Company for $8,000 which General Manufacturing Company claimed was fictitious. In addition, General Manufacturing Company took a credit of $2,000 for defective merchandise, not recorded by X Machine Company.

Y Assembly Company disbursed substantial sums on behalf of General Manufacturing Company during the first three months of the latter's existence. An "Advances" account was used by both companies.

Analysis of the Advances account follows:

	Charges to Gen. Mfg. Co. On books of Y Assembly Co.	*Credits to Y Assembly Co. On books of Gen. Mfg. Co.*
Sale of Machine for Y Co. by Gen. Mfg. Co.	$ 3,000	....
Insurance	2,000	$ 2,000
Legal expenses	200	....
Freight	430	....
Advertising	125	....
Machinery	....	25,000
Supplies	10,050	....
Payroll	11,190	....
	$26,995	$27,000

Y Assembly Company also purchased parts from X Machine Company and sold them to General Manufacturing Company.

The books of the three companies involved showed the following entries in connection with these transactions:

(1) On the books of X Machine Company:

Y Assembly Company	$55,000	
Sales		$55,000

(2) On the books of Y Assembly Company:

Purchases	$40,000	
X Machine Company		$40,000
General Manufacturing Company	$85,000	
Sales		$85,000

(3) On the books of General Manufacturing Company:

Purchases	$65,000	
Y Assembly Company		$65,000

X and Y were unable to reconcile their differences and a Special Master in Chancery was appointed in January 1946 to find an equitable reconciliation.

His findings were as follows:

(1) X Machine Company's bill to General Manufacturing Company of $8,000 was entirely unsupported and therefore disallowed.

(2) General Manufacturing Company was entitled to $1,000 credit for defective merchandise.

(3) Expenses disbursed by Y Assembly Company on behalf of General Manufacturing Company were allowed except for the following:

(*a*) Legal expense to be borne equally

(*b*) Advertising allowed in amount of $25 only

(*c*) Payroll overstated on Y Assembly Company's books by $325

(4) The machine recorded on the books of General Manufacturing Company actually was owned by Y Assembly Company. General Manufacturing Company had deducted $625 depreciation for the three-month period. Y Assembly Company had also deducted $625 depreciation. This machine was used by General Manufacturing Company from date of acquisition on July 1, 1945, to October 1, 1945, when it was sold by General Manufacturing Company for $27,375, or $3,000 in excess of adjusted book value. Y Assembly Company charged General Manufacturing Company with $3,000 representing actual profit of $2,375, plus rental charges of $625. This was allowed. The $3,000 was credited to Cost of Sales on Y Assembly Company's books.

(5) As to sales by X Machine Company to Y Assembly Company and by Y Assembly Company to General Manufacturing Company, X Machine Company should have charged Y Assembly Company $50,000 and Y Assembly Company should have charged General Manufacturing Company $70,000.

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